Globalization and Catching-Up in Transition Economies

Grzegorz W. Kolodko

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1. *Post-Communist Transition: The Thorny Road*
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Preface

Since the terrorist attack on the United States on September 11, 2001, almost everyone agrees that the world has changed and never again will be the same. Definitely, there have been major changes since the attack on New York and Washington, and on the U. S. A. as such, but some things will remain the same. And that is so because the world had already changed before the atrocities of September 11 and the reactions to these events.

The world has already changed in a remarkable way because of ongoing globalization and post-communist transformation. These two all important features of the turn of Twenty First century are discussed in this book, especially from the perspective of the Great Transition Depression, which—fortunately—is already in the past, and the fast long-term growth, which—hopefully—is still in the future.

It is strange, but globalization and transformation are often not considered in the same context, or as two interrelated aspects of one bolder process. Yet they should be, because there is a clear feedback between these two phenomena. Aside from the internal forces and external mechanisms, globalization acts as a galvanizing factor, which pushes forward and accelerates the process of post-communist transformation. On the other hand, globalization would be incomplete if the post-communist economies were not integrated into the global economy. After all, the latter would not even deserve to be called "global" unless it encompassed such a large part of the world as the post-communist countries of Eastern Europe. They constitute a large part of the world in terms of population (about one fourth) and land (about one third), but not in terms of contribution to the world economic output.

But—as we know—much has changed and the world, from an economic viewpoint, never will be the same again. The postcommunist economies seem to be coming out from the most difficult period of early stages of transformation and in the long-term future they have an excellent chance to grow fast, much faster than the world economy on average and for certainly faster (perhaps even twice as fast) than the advanced economies of the West. The Chinese accomplishments during the decades of the 80s and 90s have proven this already and now the question arises: will it be possible for other countries emerging from the legacy of centrally planned economy and communist state to also grow as fast economically? Of course, East Central Europe is very different from China, as are also the former Soviet republics. Yet in the latter case relevant differences sometimes are not that significant.

In the chapters that follow I try to argue that indeed a scenario for a significant step forward—without any unnecessary shocks, but with all needed therapy—is likely and fast growth of post-communist markets is feasible. Basically, it will depend on the quality of implemented policies and, to have such, they must be based on a correct theory. Hence the debate about the theoretical explanation of the post-communist transformation in the wider context of globalization must continue. The more it is needed, the more new questions are lying ahead.

This is the second book which I have written and published within the Rochester Studies in Central Europe. The previous one (Volume 1)—released by the University of Rochester Press in November 2000—is entitled *Post-Communist Transition. The Thorny Road*. The road remains thorny indeed to transform the former centrally planned economies, state-controlled societies and non-democratic regimes of East Central Europe and the former Soviet Union into the free market economies, civic societies and political democracies.

These issues are elaborated in a systematic and comprehensive way also in one of my earlier books, namely in *From Shock to Therapy. The Political Economy of Postsocialist Transformation* published in 2000 by Oxford University Press. Together with this work—*Globalization and Catching-up in Transition Economies*—these three books make a kind of trilogy on the politics and economics of the fast post-communist changes, not only in East Central Europe and the former Soviet Union, but also in the Asian countries going through vast process of changes including, of course, China.

Therefore, the considerations and conclusions presented here seem to be relevant to as many as about 30 countries in Europe and Asia (and soon also in Cuba) and to 1.7 billion people living there. They have the right to expect a better future and certainly some of them may be able to catch-up with the more economically advanced countries. This, however, depends on the chosen strategies for development and policies for reforms. Globalization, being itself an indispensable process, ought to be seen in this context as an additional factor, which must be taken carefully into account in a search for such strategies. Globalization—that is liberalization and integration of several autonomous markets into one global market of free flow of information, technology, goods and capital (and, to a lesser extent, labor)—creates both an additional risk and additional chances for the emerging markets and democracies, including the post-communist ones.

Yet the question remains: to what extent and by what means will they use these chances to their advantage? And how much can they accelerate the rate of economic growth and the scope of the progress vis-à-vis social development, and to what extent will they be able to overcome the risk brought by intensifying competition within the global market? It seems

that in this changing world—which indeed has neither been the same since the end of the Cold War and collapse of the Berlin Wall, nor will be the same in the future due to irreversible globalization—there are more new chances than risks for the post-communist countries' development. It is up to them to maximize the former and neutralize the latter.

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Chapter One

Introduction

The historical endeavor of the transformation from a statist-controlled economy to new institutional arrangements of a free market economy is a unique undertaking. Ongoing transition in the former centrally planned economies of Eastern Europe (EE) and the former Soviet Union (FSU)[1] is an indispensable part of globalization. Without this transition globalization would fall short of its full dimension, comprehensiveness and dynamism. Leaving aside the political and ideological concerns, the main argument in favor of transition to a market system has been a wide conviction that the introduction of a market economy should improve competitiveness and efficiency. Hence—after some short period of transitional contraction—the new system is supposed to lead to recovery and, later, to fast growth. However, for a number of reasons it has not occurred. Transitional recession lasted much longer than expected, contraction was deeper than assumed earlier, and the recovery was not—and in several cases still is not—as smooth as envisaged both by the relevant governments and the international organizations. Actually, instead of a rapid recovery and robust growth, the lasting recession rather turned into the Great Transitional Depression, continuing in some countries over the whole decade of the 1990s. Moreover, it is important that such a great depression happened to its full extent in the two biggest transition economies, Russia and Ukraine, with a population of about 200 million, or about a half of all the people in the countries in transition to a market system.

While after the first decade of transition, i.e. 1990–99, the index of average (weighted) gross domestic product (GDP) for the twenty-five countries

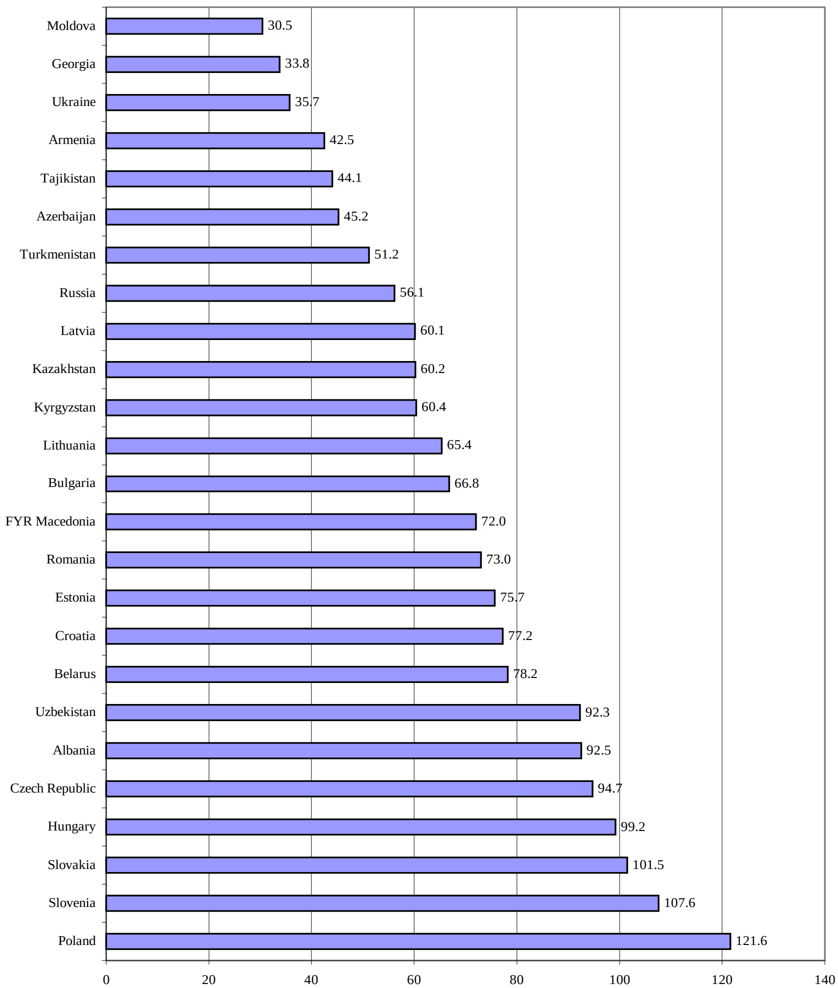
1. Henceforth—unless otherwise stated—the Baltic republics, i.e. Estonia, Latvia and Lithuania, though they belonged to the former Soviet economies, are counted as the East European countries. In recent years this has been a common practice, including among international organizations. Thus we are dealing with two major groups of transition economies, that is Eastern Europe, including the three Baltic states (EE), and the twelve former Soviet republics, that is the Commonwealth of Independent States (CIS). China and Vietnam are not taken into consideration in this context, since these countries are rather aiming still at reforming the existing economic system than at replacing it by an entirely new institutional set-up.

of EE and CIS stands at around 65 percent of pre-transition output, it is as low as around 54 percent for the CIS economies and still below the level from 1989—around 95 percent—in the case of the EE economies (Figure 1).[2] By all means that was not expected at the onset of transition. Furthermore, the surprise stemming from these unforeseen developments causes significant differences vis-à-vis the interpretations of occurring events. It is true both for the explanations of the causes of such a long-lasting contraction and, later, the sources of fast growth (in those countries where it has indeed happened) are concerned. Thus it is worth looking for the patterns underlying these processes in transition economies, especially from the viewpoint of policy options for the future and their political and technical constraints.

Consequently, after the Introduction, chapter 2 briefly discusses the links and feedback between globalization and transition to a market economy. In chapter 3 the scope and dynamism as well as the general causes of deep transitional recession are presented. Chapter 4 describes various paths of recession, recovery and growth, because these processes evolve along quite different routes in certain countries and regions of the EE and FSU. Chapter 5 elaborates on policy responses towards the challenge of prolonged transitional depression, while especially stressing the meaning of institutional vacuum and the importance of the following institution-building. Chapter 6 brings into consideration the problem of market imperfections and their implications for the redesigning of the government's role. In chapter 7 the issue of small versus 'big government' returns, and the link between the size of the government and the pace of economic growth is reconsidered. In chapter 8, on one hand, the implications of globalization and external shocks upon the recovery and growth are discussed and, on the other hand, the chances and mechanisms of the catching-up with highly developed industrial economies are examined. Chapter 9 presents both the passive scenarios of alternative growth paths in transition economies as well as the active policies aiming for growth acceleration and its sustainability in the long term. Finally, in chapter 10, the policy conclusions are presented for further debate.

2. The evaluation of GDP for Yugoslavia (Serbia and Montenegro) and Bosnia-Herzegovina is not taken into account here, due to the lack of reliable and consistent data. Yet if they were included, it would only change the overall picture for the worse. Data for 1994–99, based upon the evaluation of international organizations and PlanEcon (1999b) is presented in Table 3. Also the Mongolia's GDP—equal to about 1 billion current USD and thus matching only about 0.1 percent of total aggregated GDP for all transition economies—is not taken into account here; however doing so would not change an overall picture.

Figure 1: Index of Real GDP 1999 (1989=100)



Chapter Two

Globalization and Postsocialist Transformation

The last decade of the twentieth century has been marked by immense changes in the world economy. The new phase of technological revolution occurring within the countries and continents' borders, on the one hand, and far-reaching internationalization of capital flow, on the other, have changed the patterns of economic performance. Broad trade liberalization, accompanied by growing liberalization of the financial and capital markets, has brought new prospects and new challenges. These challenges must be tackled not only by governments and various international organizations, but to an even greater extent by the private sector and non-governmental organizations (NGOs). Hence, on the eve of the new century, there are not only old structural problems that are increasing, but also several new issues that must be addressed properly by theoretical considerations as well as by sound policy response.

First, the private sector ought to be not only the main beneficiary of the fruits of globalization and transition, but it must be engaged more than up to now in crisis management. The role of private business is growing worldwide, both in advanced market economies and in developing and formerly centrally planned economies—in the latter mainly owing to vast privatization taking place there. The private sector, hence, must bear larger responsibility for the outcomes of the crises when they occur. To be sure, from time to time they will do so, regardless the efforts taken to avoid them. The private sectors in advanced industrial countries—including various financial intermediaries, investment banks and funds, the hedge funds, and still further merging multinational corporations—while getting involved more and more in business on the global scale, must also be more concerned about sharing the responsibility and the costs, when the international flow of capital fails to deliver positive results.

Second, the international organizations—including regional development banks and institutions dealing with particular aspect of international and global economic activities (i.e. IMF, WB, WTO, UNCTAD, ILO, etc.)—must coordinate their actions in a well-orchestrated way. Despite advancing liberalization, or in some sense because of it, there are certain intertwined processes being monitored by different organizations that are not capable of coordinating their policies sufficiently. Many problems on the global economic scene, including its postsocialist theatre, have evolved be-

cause of a lack of such coordination. A good example here is a risky situation of unregulated flow of short-term capital, which could help and facilitate economic growth in emerging markets, but might also make it more difficult. Unfortunately, in the late years of the last decade the latter was often the case. If the risk evolving from rampant trade liberalization is augmented by the risk coming from radical financial liberalization, these risks escalate critically, particularly in economies with weak institutions. And this is often the case in emerging markets, especially among the postsocialist countries.

Third, the international NGOs are going to play a much more important role on the global scene, including the economic part of it, than they have done so far. Thus they must be seen as the strategic partner for the private sector, the governments, and their international organizations. The recent case of coordinating the actions (if not yet the policies) towards debt reduction for highly indebted poor countries (HIPC) is a good example of such work and may turn out to be a good message for the future too. If the leading developed countries from the G-7 group, as well as the International Monetary Fund and the World Bank, work out the challenge of the debt burden together with some NGOs, like Oxfam and Jubilee 2000, then the effects will be visible. The future will definitely bring more initiatives of a similar type, in particular regarding investment in human capital and natural environment protection, on the one hand, and, on the other, counteracting poverty and inequality, which are still rising on a global scale. Transition economies also will be increasingly involved in these types of endeavors. It will work on behalf of their ability to develop faster, since these activities are linked to the learning process and to more favorable participation in the global economic interchange.

Fourth, the systemic transition to a market economy occurring in postsocialist countries has a significant meaning for globalization. Some of these countries are clearly on the path towards a full-fledged market economy. Some others—while still attempting to reform their existing economic system, for example, China—will most likely join this process soon. All three aspects of transition, that is, liberalization-cum-stabilization, institution-building, and the restructuring of industrial capacity, are related to the internationally occurring processes (Kolodko 1992b).

Liberalization-cum-stabilization is linked to the process of opening up previously relatively closed economies. That is reflected not only in the fact that, due to higher participation in international division of labor, their imports and exports are growing faster (or, during contraction, falling more

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1. The World Bank (1997c) has seen the share of the transition economies' exports growing from 3.0 percent in 1992 to 3.6 percent in 2020 and the share of imports growing respectively from 3.4 to 3.9 percent. It is supposed to occur in the future due to the growth of the former at an average rate of 6.2 percent and the latter at an average rate of 5.9 percent over the entire period of 28 years.

slowly) than overall output.[1] It means also free entry to and exit from liberally regulated businesses for both domestic and international entrepreneurs. In addition, capital flow has been liberalized as well, thus making the infant capital markets of those countries a part of the global integrated financial and capital markets very quickly. International investors enter especially the financial and utilities sectors. This not only causes progress as far as quality of services provided by these sectors is concerned, but also a risk of a kind of 'dependent capitalism' (Poznanski 1997). Such risk stems from the asymmetry between the scope of capital being invested by transnational corporations and foreign investors in these countries, on the one hand, and the lack of ability of these countries to raise enough capital to invest into foreign markets, since they are short of capital to meet their own needs, on the other hand. This challenge can be overcome only in the long run, assuming that financial stabilization is accomplished, the fundamentals are sound, and the growth is fast.

Institution-building, especially through new laws and organizations facilitating the market-based allocation of recourses, is linked to globalization too. There are several institutional arrangements that are at the same time intensively a part of international and global institutional order, for example, regulation vis-à-vis trade liberalization agreed within the framework of the WTO, or standards and policies aimed at protecting the natural environment. An indispensable part of globalization—and not a contradiction to it—are the processes of various regional integration, for example, with (and later within) the European Union and, after initial disintegration, within the CIS. During globalization the national economies' institutional arrangements are becoming more similar to each other and the more similar they become, the easier it is to enhance the process of integration and globalization.

All these reforms lead to microeconomic restructuring of the existing industrial capacity. To a large extent it takes place simultaneously with the expanding involvement of multinational corporations. Thus a growing part of the production and distribution processes in transition economies can be seen simply as a fraction of the global economy. Increasing inward foreign direct investments (FDI) are making important contributions to this process. Nonetheless, the crucial meaning for future growth will have a propensity higher that that achieved so far to save and, consequently, a higher capability for domestic capital formation (Kolodko 1999b).

From this perspective, a sustained influx of FDI must be seen only as an addition to a healthy flow of domestic capital. Owing to globalization it should continue, even after the privatization process, which had been so strongly attracting the internal FDI expansion in the 1990s, is completed. Therefore, it ought to be expected that in the future the FDI will also be targeting microeconomic restructuring and thus will contribute to rising competitiveness in the long run. All these ought to enhance still further the growth ability in transition economies.

Chapter Three

Transitional Recession and the Great Depression of the 1990s

Before the historic endeavor of transition to a market economy has been launched, the formerly centrally planned economies were growing. Indeed, they were growing fast. Over the four decades preceding the 1990s the annual rate of growth had averaged from 4.8 percent in the former Czechoslovakia to 8.2 percent in Romania.[1] With such a pace of growth the national income was doubled in sixteen years in the former case, and in less than nine in the latter. However, growth under a centrally planned system had numerous specific features. At least five of them are worth mentioning in the context of the method of reasoning relevant in these considerations.

First, despite stubborn attempts of the governments—or indeed quite often because of their intervention in economic matters and owing to the bureaucratic allocation of resources—there were specific growth cycles (Bauer 1978, Kolodko 1976 and 1986). Although the output was growing systematically, the medium-term rate of growth was fluctuating up and down. There were periods of accelerated growth, and then—due to too extensive investment drive and the necessity to allocate more resources towards consumption's upgrading—there were periods of correction, during which the growth slowed down. Later, another expansion was launched and the sequence, by and large, was repeated (Table 1). These two features—the endogenous mechanism of periodical fluctuation and the relatively regular character of these changes—justify the interpretation of those processes as of a cyclical nature.

Second, the growth was of a 'bad quality', since even in relatively better performing economies the shortage syndrome was never eliminated entirely. That in turn was causing serious economic and political stress. Price distor-

1. There might be certain doubts and concerns about the reliability of data from that period. It could happen that, owing to methodological reasons as well as because of the political bias, the data about the pace of growth for some periods is not accurate. If it is not, then it is surely exaggerating the range of growth than underestimating it. However, if there are certain errors involved, it should make neither the long-term analyses, nor the comparisons between particular countries impossible. The conclusions drawn from these analyses must be taken with a proper care and reservations. So they are.

Table 1. Economic Growth Cycles in Centrally Planned Economies, 1950–89

	Years/Growth rate in net material product, percent											
Bulgaria	na	1953–56	1957–59	1960–63	1964–67	1968–71	1972–75	1976–80	1981–85	1986–88	1989	
		6.5	14.0	6.0	9.1	7.4	8.3	6.4	3.5	5.2	0.5	
		–	+	–	+	–	+	–	–	+	–	
Czechoslovakia	1950–52	1953–56	1957–61	1962–65	1966–69	1970–75	1976–78	1979–84	1985–88	1989		
	10.0	6.5	7.4	0.8	7.2	5.3	4.7	1.8	2.4	1.9		
		–	+	–	+	–	–	–	+	–		
GDR	1950–52	1953–56	1957–59	1960–63	1964–69	1970–75	1976–86	1987–88	1989			
	18.0	6.7	8.7	2.2	5.0	5.7	4.4	3.3	2.5			
		–	+	–	+	+	–	–	–			
Hungary	na	1951–53	1954–56	1957–60	1961–65	1966–69	1970–74	1975–78	1979–85	1986–88	1989	
		9.3	2.0	11.0	5.4	7.2	6.2	5.0	0.9	1.6	0.4	
			–	+	–	+	–	–	–	+	–	
Poland	1950–53	1954–57	1958–63	1964–68	1969–70	1971–75	1976–78	1979–82	1983–85	1986–88	1989	
	9.8	9.1	5.4	7.1	3.7	9.8	4.9	–2.7	4.9	3.9	0.2	
		–	–	+	–	+	–	–	+	–	–	
Romania	na	1951–53	1954–56	1957–59	1960–62	1963–66	1967–70	1971–76	1977–79	1980–84	1985–88	1989
		17.0	5.0	10.6	7.6	10.5	7.0	11.5	7.7	4.0	5.4	–5.8
			–	+	–	+	–	+	–	–	+	–
Soviet Union	1950–51	1952–53	1954–56	1957–63	1964–68	1969–73	1974–78	1979–88	1989			
	16.0	8.2	11.6	6.0	8.2	6.5	5.0	3.3	2.6			
		–	+	–	+	–	–	–	–			

Sources: Central Statistical Office (GUS), Warsaw, various years, and author's calculations.

'+'—acceleration. '–'—slowdown.

tions were leading to additional obstacles to sustaining a high and stable rate of growth. At the later stage, in some countries the shortages became accompanied by open (i.e., price/wage) inflation. Thus so-called 'shortageflation' syndrome had emerged (Kolodko and McMahon 1987). Consequently, growth was associated with lasting disequilibrium (Kornai 1986). Under the statist economy and central planning allocation that was just opposite to what was expected by the authorities.

Third, despite a high rate of growth the living standard was not improving fast enough. The socialist model of development had been based upon firm expansion of heavy industries and the investment drive, so consumption was always slowing down. Owing to the cyclical nature of growth, the rate of consumption growth fluctuated too, yet the highest variation was vis-à-vis the investments. Nevertheless, too slow (at least from the people's expectations perspective) improvement of standard of living was causing increasing social dissatisfaction, which in turn was causing a further loss of momentum. This factor, together with the discomfort of shortages, or even shortageflation, explains why the sociopolitical system was also becoming unbalanced, despite the fact that the rate of growth of production was not that low.

Fourth, there was a 'growth fatigue' (Poznanski 1996). The pace of growth was slowing. Especially at the later stages, after the initial rapid growth in the 1950s and less in 1960s, the rate of growth significantly declined. This happened even though investments were growing faster than overall production, what shows that, once again contrary to the expectations of the governments and policymakers, efficiency was shrinking. As labor productivity was growing slower and slower, in the late 1980s growth was coming close to stagnation and in 1989 it became even more sluggish. Thus the potential for growth was fading away. Yet before the quick growth could resume, output had collapsed by unexpectedly great extent. Unfortunately, together with the arrival of transition, the recession started too. Still worse, before critical financial stabilization could be established, inflation accelerated significantly. Thus these countries, although to different degree and for a different period of time, had shifted from one malaise—that is, the shortageflation under a dying centrally planned regime—to another one—that is, the slumpflation under the emerging market order (Kolodko 1992a).

Fifth, the catching-up process was already taking place under the centrally planned system. Especially in the early years, the countries at a relatively lower level of development, for example Bulgaria and Romania, were growing much faster that the countries enjoying a relatively higher level of production and hence a better standard of living, for example Hungary and the former Czechoslovakia (Table 2). The same can be said about the pattern of growth within the former Soviet Union, where Caucasus and Central Asian republics were growing significantly faster than the East European republics did, and about the former Yugoslavia republics, where this

Table 2. Average Rate of Growth (NMP) in Centrally Planned Economies, 1950–89 (percent)

	1950–89	First Phase of First Cycle	Last Phase of Last Cycle
Romania**	8.2	17.0	5.4
Bulgaria*	6.9	>10.0	5.2
Poland	6.7	9.8	3.9
Soviet Union	6.5	16.0	3.3
GDR	5.9	18.0	3.3
Hungary**	5.0	9.3	1.6
Czechoslovakia	4.8	10.0	2.4

Source: Central Statistical Office (GUS), Warsaw, various years and author's calculations.

* Average for 1953–89

** Average for 1951–89

NMP—Net Material Product

phenomenon, though to a lesser extent, had taken place too, for instance if one compares the rate of growth of Macedonia and Slovenia.

And then the year 1989 arrived and the transition began.

Transitional recession lasted from three years in the best case—i.e., Poland from mid-1989 until mid-1992—to as many as 10 years in the worst case, i.e., in Ukraine from 1990 until 1999. In the former, GDP contracted by about 20 percent and then started to recover and grow. In the latter, output (in terms of GDP) fell by over 60 percent and is believed to start to grow only in the year 2000.

While only four countries—in addition to Poland in 1996, Slovenia in 1998, Slovakia in 1999 and Hungary in 2000—have been able to recover the pre-transitional output, at the other end of the spectrum there are countries doing, from this angle, even worse than Ukraine. In Georgia and Moldova GDP in 1999 was at about one-third of its 1989 level and in another four FSU republics it was significantly below half that level. Among the EE economies, in six countries GDP was hovering around or below three-fourths of the 1989 output (Table 3).

Thus the great slump is a fact. However, it must be emphasized that the data for transition economies is far from perfect. Of great significance here is the bias stemming from the existence of vast informal, i.e., neither officially registered, nor taxed sector. The problem is that the informal activities indeed do alter upward the official statistics for both output and employment, but they do not necessarily raise the rate of growth or mitigate the rate of contraction. In other words, it is obvious that in transition economies the factual output and thus GDP is significantly—in the range between 15 and 30 percent—higher than the one officially acknowledged (Kaufman and Kaliberda 1996).

Table 3. Recession and Growth in Transition Economies. The Rates of GDP Change, 1989–99

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Real GDP 1999 1989=100
Poland	0.2	–11.6	–7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	3.8	121.6
Slovenia	–1.8	–4.7	–8.9	–5.5	2.8	5.3	4.1	3.5	4.6	3.9	3.5	107.6
Slovakia	1.4	–2.5	–14.6	–6.5	–3.7	4.9	6.9	6.6	6.5	4.4	1.9	101.5
Hungary	0.7	–3.5	–11.9	–3.1	–0.6	2.9	1.5	1.3	4.6	5.1	4.2	99.2
Czech Republic	1.4	–1.2	–11.5	–3.3	0.6	3.2	6.4	3.8	0.3	–2.3	–0.3	94.7
Albania	9.8	–10.0	–27.7	–7.2	9.6	9.4	8.9	9.1	–7.0	8.0	7.1	92.5
Uzbekistan	3.7	1.6	–0.5	–11.1	–2.3	–4.2	–0.9	1.6	2.4	3.3	3.9	2.3
Belarus	8.0	–3.0	–1.2	–9.6	–7.6	–12.6	–10.4	2.8	10.4	8.3	1.5	78.2
Croatia	–1.6	–7.1	–21.1	–11.7	–8.0	5.9	6.8	6.0	6.5	2.3	–0.7	77.2
Estonia	–1.1	–8.1	–13.6	–14.2	–9.0	–2.0	4.3	3.9	10.6	4.0	0.0	75.7
Romania	–5.8	–5.6	–12.9	–8.8	1.5	3.9	7.1	4.1	–6.9	–7.3	–4.1	73.0
FYR Macedonia	0.9	–9.9	–7.0	–8.0	–9.1	–1.8	–1.2	0.8	1.5	2.9	0.6	72.0
Bulgaria	0.5	–9.1	–11.7	–7.3	–1.5	1.8	2.1	–10.1	–7.0	3.5	1.4	66.8
Lithuania	1.5	–5.0	–6.2	–21.3	–16.0	–9.5	3.5	4.9	7.4	5.2	0.0	65.4
Kyrgyzstan	4.0	3.0	–5.0	–19.0	–16.0	–20.0	–5.4	7.1	9.9	1.8	0.0	60.4
Kazakhstan	–0.4	–0.4	–13.0	–2.9	–9.2	–12.6	–8.2	0.5	2.0	–2.5	–1.7	60.2
Latvia	6.8	2.9	–10.4	–34.9	–14.9	0.6	–0.8	3.3	8.6	3.6	1.5	60.1
Russia	2.6	–4.0	–5.0	–14.5	–8.7	–12.7	–4.1	–3.5	0.8	–4.6	1.5	56.1
Turkmenistan	–6.9	2.0	–4.7	–5.3	–10.0	–18.8	–8.2	–8.0	–26.1	4.2	17.0	51.2
Azerbaijan	–4.4	–11.7	–0.7	–22.6	–23.1	–19.7	–11.8	1.3	5.8	10.1	3.7	45.2
Tajikistan	–2.9	–1.6	–7.1	–29.0	–11.0	–18.9	–12.5	–4.4	1.7	5.3	5.0	44.1
Armenia	14.2	–7.4	–17.1	–52.6	–14.8	5.4	6.9	5.8	3.1	7.2	4.0	42.5
Ukraine	4.0	–3.4	–11.6	–13.7	–14.2	–23.0	–12.2	–10.0	–3.2	–1.7	–2.5	35.7
Georgia	–4.8	–12.4	–20.6	–44.8	–25.4	–11.4	2.4	10.5	11.0	2.9	3.0	33.8

Table 3. ***(Continued)***

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Real GDP 1999 1989=100
Moldova	8.5	–2.4	–17.5	–29.1	–1.2	–31.2	–3.0	–8.0	1.3	–8.6	–5.0	30.5
Bosnia-Herzegovina	na	na	na	na	na	na	*–5.7*	*58.9*	*50.1*	*19.4*	*6.6*	x
Yugoslavia	na	na	na	na	na	*2.5*	*6.1*	*5.8*	*7.6*	*1.5*	*–37.3*	x
GDP-weighted average*												
EE-13	–0.2	–6.6	–10.7	–3.6	0.4	3.9	5.5	4.0	3.6	2.4	1.7	99.3
CIS-12	0.6	–3.7	–6.0	–14.2	–9.3	–13.8	–5.2	–3.5	0.9	–3.5	0.3	54.3
EE and FSU-25	0.3	–5.0	–8.1	–9.5	–5.0	–6.0	–0.5	–0.2	2.0	–1.2	1.07	1.3

Sources: EBRD 1999. Data for Russia for 1989 is for Soviet Union; source as in Table 1. Preliminary data for 1999 also from PlanEcon 1999a and 1999b, and from available national statistics. Data for Bosnia-Herzegovina, and for Yugoslavia from PlanEcon 1999b.

*The weights used are the EBRD estimates of nominal dollar-GDP for 1996.

na—data not available.

Though it changes only the basis from which the pace of growth should be counted, it does not change the rate of growth as such. Accordingly, contemporary—in 2000 and beyond—overall GDP as well as GDP per capita (and consequently GDP absorption, e.g., private consumption and investment) are both higher than it may be read from the official data provided by particular governments and international organizations. The reason for this otherwise good news is not faster than registered economic growth, but higher output at the point of departure. Hence these observations might change the understanding and interpretation of the absolute level of output, but not its dynamism.

It must also be admitted that, in some cases, the range of decline of output could be exaggerated at the onset of transition. It might be so, since part of the factual production did not vanish, but rather was transferred (most often together with the assets) from the official to the informal sector. Such particular form of privatization (since the official sector used to be state-owned and the unofficial became a private one) resulted in a pace of growth larger than the official figures. Often the output, which did exist before, yet was not registered, had turned out to be gradually recorded and thus counted in the official statistics.

Moreover, this process still continues and will continue as long as the informal economic activities are incorporated into the legal economy. Basically, that is due to further progress of financial stabilization and its consolidation into stability, on the one hand, and enhancement of institutional arrangements friendly to the market system, on the other hand. So, under such circumstances, the data suggest growth within some additional range, yet actually it is not taking place. Only what has been produced already earlier, now is counted in the national statistics.

Therefore, the phenomenon of the informal sector is bringing two types of bias to the real picture of initial contraction and recovery. First, it could happen that the real scope of contraction was exaggerated, but later the real growth could be exaggerated as well. Interestingly, in many analyses much more attention has been given to the former case than to the latter. The point is that in the longer run—say, in a period of a decade or two—the balance of these two contradictory phenomena may be neutral.

There was always a belief that growth would come sooner than indeed it did. For instance, in Poland, at the beginning of the transition, the government assumed that the contraction would last just one year and the fall of GDP would not exceed 3.1 percent. Actually, it lasted three years and was six times more severe.[2]

2. Despite the official statistics—accepted also by the international organizations, including the IMF, World Bank and EBRD—a dispute about the actual drop of output in Poland continues. There are authors (for example Berg and Sachs 1992, Czyzewski, Orlowski and Zienkowski 1994, DeBroeck and Koen 2000) trying to challenge the scope of transitional recession reflected in official data. However, the evidence seems to be clear that there was a drop within the range of about 20 percent over the period of three initial years of transition.

Gomulka (1990) was predicting the rate of growth for 4.7, 8.7 and 7.9 percent from 1991 to 1993, respectively, which altogether would bring sound expansion of about 22 percent in those three years, whereas actually the economy had contracted after the fall of about 12 percent in 1990 by an additional 7.0 percent in 1991 and then grew by just 2.6 and 3.8 percent in 1992 and 1993, respectively.[3]

Borensztein and Montiel (1991), though assuming better policy response and structural reforms, had forecast a 6.5 percent rate of growth, on the average, from 1991 to 1995 for Hungary and Poland and 3.25 for the former Czechoslovakia.

Summers (1992) expected that the Polish economy would turn around already in 1991 (2.0 percent growth) and thereafter would soar by five or six percent yearly. He had foreseen the positive growth in case of Hungary, Poland, Romania, and Yugoslavia since 1992, and in the case of Bulgaria and Czechoslovakia since 1993, with the acceleration of non-weighted mean rate of growth for the whole EE going up from 0.8 percent in 1992 to about 4 percent by the end of decade. On the contrary, it shrank by an additional 3.6 percent in 1992 (after a drop of about 17 percent in 1990–91), and at the end of decade, i.e., in 1998–99, it was expanding by only about two percent.

Not only were the individual experts wrong, but so were the governments and respected international organizations. The International Monetary Fund in its *World Economic Outlook 1991* had been expecting GDP growth for EE already since 1992. After predicting a contraction of only 1.5 percent in 1991 (contrary to the actual collapse of output by 10.7 percent in that year) the GDP growth was forecast at 2.8 percent for 1992 and at 4.4 percent for 1993 (IMF 1991), yet it dropped in the former by 3.6 percent and then increased by just 0.4 percent in the subsequent year.

And then the pendulum of expectations shifted to the other extreme. In the October 1992 issue of *World Economic Outlook*—under the influence of the data showing for 1991 a severe contraction of 10.7 percent in the EE economies and 6.0 percent for the FSU—the forecast had been changed significantly. For the EE countries, instead of earlier expectations of 2.8 percent growth in 1992, there was a forecast of 9.7 percent recession. As for the FSU economies, the forecast for that year was minus 18.2 percent, yet actually GDP contracted ‘only’ by 14.2 percent.

3. Interestingly, despite such bitter experience with greatly exaggerated and too optimistic predictions—and in addition to the deep slowdown of 1998–99, when the rate of GDP growth in Poland had declined from 6.3 percent, on average, in 1994–97 to 4.8 and about 4.0 percent in 1998 and 1999, respectively—he forecasts for 2000 a rate of growth within the range of 6.0 to 7.0 percent (Gomulka 2000). Other, more realistic, forecasts foresaw GDP growth for this year within the range of 4.2 to 5.2 percent. For instance, the former was the forecast of Citibank Poland and the latter was the official target of the Polish government. In reality the GDP growth was 4.0 percent in 2000 and a meager 1.5 percent in 2001

There have been, of course, a number of reasons that the early forecasts turned out to be overoptimistic, i.e., wrong, and that the expectations were not met. The range of uncertainty vis-à-vis especially the early transition and towards the results of the then ongoing vast and comprehensive change upon the level of output and its dynamic was indeed huge. Thus it was not that difficult to be wrong because of the substance of the process. Yet the issue is that the true mistakes had been much more about the policies and their theoretical foundation than simply about the forecasts. The latter were not accurate, because the former was mistaken (Kolodko 1991 and 1999d, Nuti 1992, Poznanski 1996, Stiglitz 1998a). Thus what has caused such a deep contraction that in so many cases has turned out to be a decade of lasting depression of economic activity at the very basic level?

By all means it is not possible to explain the Great Transitional Depression of 1990–99 either by the legacy of the past, or by the external shocks exclusively (Mundell 1997). This set of factors, of course, does play a meaningful role; however they are not to be blamed for all that misfortune, since it is indeed a great misfortune to lose a half or so of GDP over a decade. The crucial role in these events had been played by the policy and that policy was often wrong. Among the weakest part of this incorrectness was the initial negligence of the role of the institutional aspect of building a market system. Emerging market economy performance depends much more on the institutional arrangements than simply on overall economic liberalization.

Therefore, the discussion on the platform 'too fast versus too slow' liberalization and privatization has been led along the lines of the wrong alternative (Kolodko and Nuti 1997, Stiglitz 1998a). The theoretical question and pragmatic challenge were not about the pace either of liberalization or privatization, but about the ways these two processes were designed and coordinated (or, more precisely, often not coordinated) with institution-building.[4] If the institution-building was not enhancing the former processes, then there was a lack of compatibility among the elements of the multi-track process of transition. As a result, instead of growing, the microeconomic efficiency was further eroding, leading to such a long and deep decline in output.

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4. In the extreme cases of both the large economies, such as Russia, and the small, such as Albania, it had happened that with an even bigger private sector (in terms of contribution to GDP) than in other countries, as for example in Poland or in Slovenia, the overall performance was much worse. Hence, the scope of the liberalization and the range of the private sector were not decisive in the changes of efficiency, but the institutional vacuum in the former countries and relatively sound arrangements and good policies in the latter.

Chapter Four

Different Paths of Contraction, Recovery, and Growth

There is a further strong, although indirect argument convincingly proving that policies that have been actually executed are of critical importance for recession and growth, not the legacy from the past, or bad or good luck. The legacy sometimes may help, but in the postsocialist economies it more often hinders. Yet whatever is such a legacy, the policies do decide. This argument is based on the fact that, despite many structural, institutional, geopolitical and cultural similarities between these countries, they have been moving along quite different paths over the first decade of transition (EBRD 1999, Kolodko 2000a, Blejer and Skreb 2000). These paths have been (and are going to continue to be) much more shaped by the policies than by any other factors. And that is the main cause that whereas in certain countries the transitional recession lasted just three to five years, in some others it continued over the entire 1990s. Therefore, the current, i.e., the 2000 level of output, is a function of two occurrences. First, it is a result of the seriousness of output decline during the particular years of recession. Second, it is a consequence of the numbers of such years.

In some countries the contraction lasted for a shorter period of time, yet altogether it was deeper owing to more severe decline of output during that time. In some others the recession lasted for a longer period, yet it was milder because production dropped to a lesser degree in subsequent years. In the two countries most deeply affected by the Great Transitional Depression—that is in Moldova and Georgia—in 1999 GDP stood at about one third of pre-transition level. Whereas it is the outcome of eight years of contraction and two years of growth in the former case, in the latter it is the result of six years of contraction and four years of growth. Whereas there are countries, like Armenia, suffering recession for a period of only four years though it was enough to bring their national income down to about 40 percent of pre-transition level, there are also countries like Romania, where the output had been falling for seven years, nevertheless by 1999 it was brought down just to 76 percent (Table 4).

Transition is a unique process by its very nature and substance. So even more is the transitional recession, depression and recovery. There are ex-

Table 4. Duration of Recession and Growth in 1990–99 (in number of years)

	Transitional Recession	Recovery	Second Generation Contraction	Growth	Total Contraction	Years of Growth
Albania	3	4	1	2	4	6
Armenia	4			6	4	6
Azerbaijan	6			4	6	4
Belarus	6			4	6	4
Bulgaria	4	2	2	2	6	4
Croatia	4	5	1		5	5
Czech Republic	3	5	2		5	5
Estonia	5			5	5	5
FYR Macedonia	6			4	6	4
Georgia	5			5	5	5
Hungary	4			6	4	6
Kazakhstan	6	2	2		8	2
Kyrgyzstan*	5			4	5	5
Latvia*	3	1	1	4	4	6
Lithuania	5			5	5	5
Moldova	7	1	2		9	1
Poland	2			8	2	8
Romania	3	4	3		6	4
Russia	7	1	1	1	8	2
Slovakia	4			6	4	6
Slovenia	3			7	3	7
Tajikistan	7			3	7	3
Turkmenistan*	7			2	7	3
Ukraine	10				10	0
Uzbekistan*	5			4	5	5

Source: Author's compilation based on data from Table 3.

In countries labeled with * there was growth until 1990 and transitional recession started only in 1991.

treme examples of annual drop of GDP in excess of 50 percent (Armenia in 1992) and growth of 17 percent (Turkmenistan in 1999). It is possible to spot huge differences between the highest rates of contraction and growth for the same year; in the most extreme case such gap exceeded 55 percentage points and that was in 1992. Even in the tenth years of transition, i.e., in 1999, this difference was still larger than 20 percent. Altogether, there are as many as fifty-seven cases of years with two-digit rate of contraction, but (not surprisingly) only seven cases of years with two-digit rate of growth. To be sure, after the initial collapse of output, the more the transition process had been advanced, the lower had been the fluctuations of the rates of growth (or contraction, if the growth had not come yet). Thus the processes ongoing vis-à-vis production activities are becoming less hectic and more easily manageable from the viewpoint of macroeconomic policy.

The worst of all those years was 1992, when only Poland—due to the recovery, which had taken off already since the middle of that year—had modest (2.6 percent) rate of growth. All other countries were suffering deep contraction within the range from minus 2.9 percent in Kazakhstan and minus 3.1 in Hungary to as much as minus 44.8 percent in Georgia and minus 52.6 percent in Azerbaijan. For the whole group of countries, the recession that year was fairly deep and accounted for minus 9.5 percent. And that had occurred when the transition was going peacefully and, unfortunately, there were local (military) conflicts in certain minor regions. Of course, in the latter case the explanation of such dramatic contraction is obvious, since these conflicts did contribute to further distortions, thus to output that dropped still further and to growing economic and social hardship.

So far the best year was 1997, that is the year when the early fruits of structural reforms had started already to ripen, but still before the East Asian contagion and the fallout from Russia's financial crisis were making their impact upon the region's economic activity (Montes and Popov 1999). In this year production fell only in five countries (including a drop of 26.1 percent in Turkmenistan, unusual for this stage of transition), whereas it was growing in remaining 20. The highest rate of growth was recorded in Georgia and Estonia—11.0 and 10.6 percent, respectively. For the entire region the rate of growth of weighted GDP on average was 2.0 percent. And then, in 1998, it fell again by 1.2 percent. It is possible and even likely that that was the last year when the contraction was reported for the whole region of both the EE and the FSU economies.

Hence, thus far there is not any clear pattern of the sequence of contraction, recovery and growth in transition economies. The first decade of this historical endeavor must be seen as a very untypical period of time, which has neither a parallel to anything in the past, nor should be expected to be repeated with similar characteristics in the foreseeable future—if ever at all. This is due to a number of specific factors influencing the developments in this regard.

First, the moment the output began to decline was somehow different in the different countries. In a few of them, for example Latvia and Uzbekistan, it occurred only at the end of 1991 and at the beginning of 1992, because of postponed and inconsistent liberalization. However, for the same reasons—that is, due to delayed structural reforms—production had already started to fall in 1989 in countries like Turkmenistan (within the FSU), or in Croatia (within the former Yugoslavia), or in Romania (within the former Comecon). Although they belonged to the same group of formerly centrally planned economies, they were not alike, though in all of them the distortions were mounting. The institutional arrangements of that time were inadequate for the challenge of the incipient globalization. Such a lack of institutional compatibility influenced economic efficiency in a negative manner. However, the initial impulse of contraction was not identical in each of the transition economies. In some of them contraction happened

because transition to a market system was just initiated, whereas in certain others it happened because it was not yet launched.

Second, the depth of the recession was different in different countries. That was, on the one hand, due to the initial distortions associated with the late centrally planned economy, and, on the other hand, due to the applied policies. The more severe those distortions were—for example, the burden of non-performing foreign debt, the rate of open inflation and the scope of shortages, the range of price subsides, the array of inefficient state companies, etc.—the deeper the following contraction was. But during the early years of transition, the range of contraction was also larger in the countries that tried to exercise more radical liberalization policy. Therefore, if both these occurrences took place simultaneously—and that was precisely the case in, for example, Poland in 1989 and Russia in 1992—the early contraction was deeper (Figure 2).[1] The opposite example—that is the case without the distortions typical for a partly reformed statist economy and with a gradual shift towards liberalization—does not exist. Nevertheless, the Chinese and the Vietnamese experiences of the 1990s show that, if there is not too much of the first characteristic and not too little of the second, afterward the growth can be fast and, at least for the time being, sustainable.[2]

Third, the duration of transitional contraction was shorter in these countries, which were able to reform their economies under the previous system. The more the economic and financial mechanism of the centrally planned economy was reformed, the shorter was the period of introduction of the critical mass of new arrangements. Consequently, it has taken less time to improve allocative efficiency and hence to return to the path of growth. This is clearly the case in Hungary and Poland as well as Slovenia.[3] This

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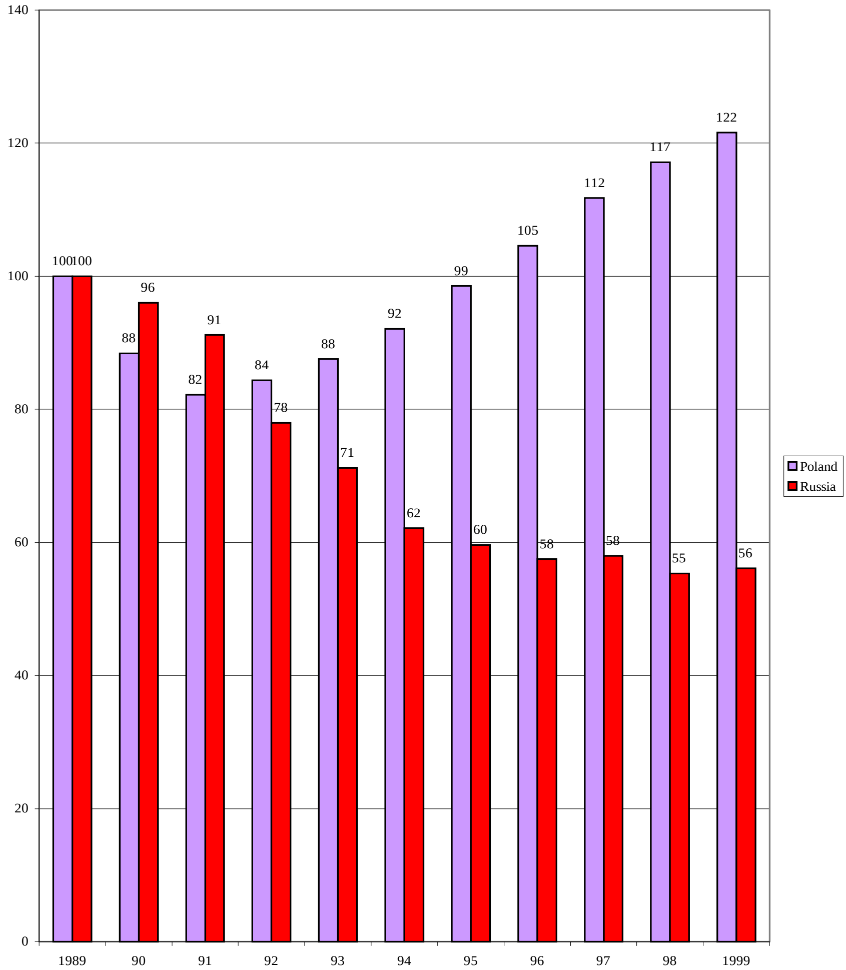
1. However, the case of Russia is quite different than Poland's. In the former, the GDP fell by 8.8 percent already in 1990–91, i.e., before substantial liberalization occurred. In the latter, there was growth until mid-1989, when the pace of liberalization was fundamentally accelerated, and only since then did the output start to fall during the subsequent three years. Considering the magnitude of distortions, no doubt it would have fallen also if the liberalization-cum-stabilization attempt was not undertaken, but under such circumstances the characteristics and consequences of recession would have been different. In Poland—owing to overshooting the stabilization policy and a trade liberalization that was too radical—GDP contracted in 1990 by as much as 11.6 percent and then, in 1991, by another 7.0 percent. Hence, it happened to be much more the result of policy mistakes than of the legacy inherited from the past. To the contrary, this legacy—that is the hybrid system that had been to a degree reformed and liberalized under previous institutional arrangements—did contribute significantly to the shortening of the period of transitional contraction. Nonetheless, in such a case three years is an extremely short period of time and under better policies it could have been even shorter.

2. The opposite tendencies vis-à-vis recession and growth in China and Russia should be seen as the most striking event in the world economy in the last decade of the twentieth century. Whereas GDP was doubled over a period of ten years in the former, it was halved in the latter. That has significant geopolitical implications for the future developments.

3. Slovenia was not as seriously affected by the regional conflicts as the other countries of the former Yugoslavia. When only such a conflict ceased to harm Croatia, this country too

Figure 2: Recession and Growth in Poland and Russia, 1989-99 (1989=100)



had taken off, enjoying 6.3 percent average rate of GDP growth in 1994–97 (same as Poland at that period). That was basically the outcome of gradual liberalization executed in the course of the 1990s, but also of the reforms carried before transition was fully launched. Later, in 1998–99, Croatian economy slowed down again, especially in 1999, owing to the new wave of regional conflict in the aftermath of the Kosovo crisis. Clearly, if not the regional conflicts, the republics of former Yugoslavia would do much better. Although suffering high inflation, a decade ago they were less distorted and better prepared than any other former centrally planned economy (along with Hungary and Poland) for the introduction of full-fledged market system. Only non-economic factors caused that it has not been the case.

claim is also supported by the experience of Estonia, where certain market-oriented reforms were also executed relatively earlier than in other countries of the FSU.[4] Such observation does not contradict the conclusion that these limited reforms, exercised prior to the transition, did contribute to growing financial destabilization as well. Therefore, this mixed outcome was also creating a mixed impact on the propensity to have first contraction and then expansion. Again, the best examples here are Hungary and particularly Poland. In this country, on the one hand, the inconclusive reforms of the 1980s led to fiscal and monetary instability. Yet on the other hand—and in the longer run it has been proved to be a much stronger factor—those changes contributed to a higher flexibility and ability to adjust. Thus, the derivative of both these contradictory tendencies for future growth turned out to be a positive one. The recovery came sooner and growth was faster, particularly from 1994 to 1997.

Fourth, even when there is a recovery following the period of contraction, it does not mean that the transitional recession and depression are over altogether. During the decade of the 1990s there were at least ten cases of returning contraction after the economy had alreadybegun to recover. So far, six cases of such 'second generation transitional contraction' have lasted for more that just one year. These events are not caused solely by the external shocks, but are happening as well due to a lack of both sound fundamentals and strong institutions that are supposed to uphold the growth when it comes. In other words, in transition economies, even more than in mature market economies, continuing growth is never a given just because it has already begun. It must be maintained by good policy, and also that might not be enough, if good institutions do not support good policy. Undoubtedly, just for that simple reason it must be expected that the future will also bring instances of falling output. Some of them will result from failure of the policies; some just form the work of business cycle mechanism. However, as far as the cases of the 'second generation transitional contraction' that have occurred recently are concerned, they have been mostly the results of wrong policies or negative external shocks, or the coincidence of both. The business cycle mechanism had not been yet set fully in motion, since it is a function of the strength of market mechanism, which is just being introduced during the transition.

Fifth, it must be remembered that if the national income was lost in the past due to the failure of the policies, its current and future growth is not a

4. Although prior to 1990 the systemic differences were much smaller among the FSU republics than they were between the EE countries, some economies within the former Soviet Union were more reformed than some others. This was most visible in the Estonia's instance, which was allowed to experiment with liberalization a little bit more than other republics, because it was the smallest of all of them. Thus, it was accepted also that the experiments with limited market-oriented arrangements could take place there relatively more vividly, without a great impact upon the whole country.

compensation for such loss. Only in the instances when the later growth is a function of the previous fall in output (happening because of structural reforms) can such a contraction be seen as a specific 'investment' necessary for gaining the fruits in the form of later growing output. Otherwise—and this is mostly the case in several transitional economies—contraction and recession simply means unrecoverable lose of welfare (Nuti 1992). Of course, such interpretation is a kind of oversimplification, since the inter-generation redistribution of income is also taking place. Thus, some people are the losers, and some others are the winners, yet at a different time span. In the very long run it does not matter that much, but the very long run always consists of very many short runs.

The first decade of transition in the EE and FSU economies has come to an end with the aggregate GDP for the whole region matching barely about 70 percent of the pre-transition level. With this evaluation in mind, the individual countries are compared from the point of view of their current output in relation to their output at the onset of transition and, of course, to the other countries' relative production (see Table 3 and Figure 1). However, it may be very revealing to take a look at their aggregated output over the whole decade of the 1990s. If a certain country has succeeded in recovering the pre-transition level of output and another country was not able to do so, most often it is interpreted that the former is doing better than the latter, at least as far as the growth process is concerned. But it may happen that in the latter case the output—in relative terms—was higher over the entire period of ten years than it was in the former country.

Consider the hypothetical four-year sequence of recession, recovery and growth in two countries. In the first, the output fell by 10 percent during the second year of that sequence and then, in the third year, returned to the previous level. In the fourth year it was still growing, yet, say, by only 2.0 percent. As a result, it was overcoming the pre-transitional level by this very fraction. Thus, the sum of output over a period of four years is equal to 392 units (100+90+100+102). In the second country, the output contracted by only one percent and then again by one percent, and then again by one percent. So, at the end of that period it stood at 97.03 percent of the level of the starting year. Thus, the sum of output over a period of four years in this instance is 394.03 (100+99+98.01+97.02). It means that, despite the fact that currently, i.e., at the end of the whole sequence of contraction–recovery–growth, the production (a one year flow) is larger in the first country (i.e. 102 units), the total aggregated production—if only the whole time span is taken into account—is larger in the second country, where the current production (again one year flow) stands at about 97 units. In the latter, with current output smaller by five units (i.e. 102–97), the sum of the four years output is by two units (i.e. 394–392) larger.

This, for instance, was the case of Slovakia and Uzbekistan. The index of 1999 GDP, when compared with 1989, is equal to 101.5 and 92.3 per-

cent, respectively. However, in the former the GDP amassed for the whole decade is equal to 883 percent of the 1989 GDP, whereas in the latter it is equal to 901 percent of the output from that year. The illustration of relevant sums of the GDP, combined over the period of entire decade of the 1990s for all twenty-five transition countries, looks interesting (Figure 3).

The message is mixed again. In certain instances, while the relative aggregate GDP counted for the entire decade is larger, simultaneously the current relative level of GDP is smaller (Table 5).

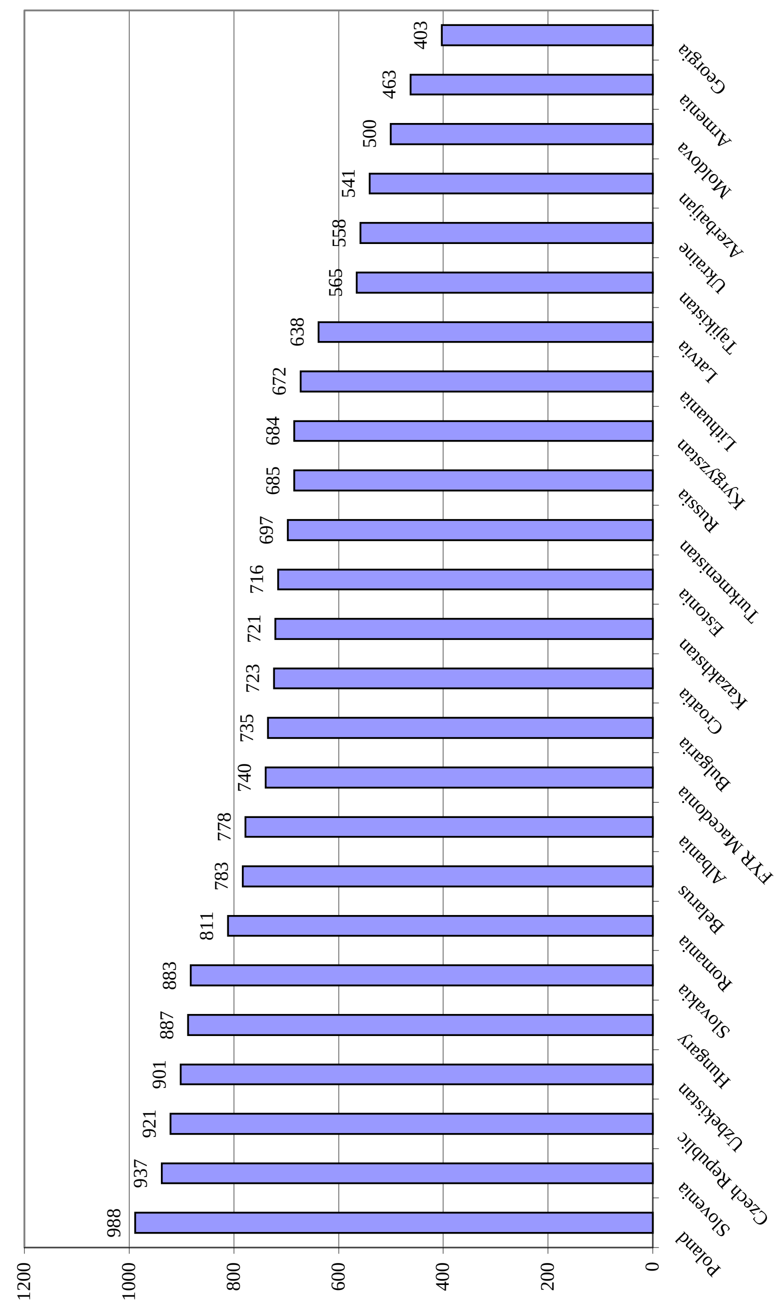
Table 5. Ranking of GDP in Transition Economies in 1999 and 1990–99 (1989=100)

	Index of Real GDP 1999 1989=100	Total GDP for 1990–99 1989=100	Ranking Index	Ranking Total	Difference between two rankings
Poland	121.6	988.3	1	1	0
Slovenia	107.6	937.2	2	2	0
Slovakia	101.5	882.6	3	6	-3
Hungary	99.2	887.3	4	5	-1
Czech Republic	94.7	920.9	5	3	2
Albania	92.5	777.8	6	9	-3
Uzbekistan	92.3	901.1	7	4	3
Belarus	78.2	783.0	8	8	0
Croatia	77.2	723.3	9	12	-3
Estonia	75.7	715.7	10	14	-4
Romania	73.0	810.8	11	7	4
FYR Macedonia	72.0	739.5	12	10	2
Bulgaria	66.8	734.6	13	11	2
Lithuania	65.4	672.5	14	18	-4
Kyrgyzstan	60.4	684.3	15	16	-1
Kazakhstan	60.2	720.8	16	13	3
Latvia	60.1	637.8	17	19	2
Russia	56.1	685.1	18	17	1
Turkmenistan	51.2	696.9	19	15	4
Azerbaijan	45.2	540.8	20	22	-2
Tajikistan	44.1	565.4	21	20	1
Armenia	42.5	462.7	22	24	-2
Ukraine	35.7	558.4	23	21	2
Georgia	33.8	402.7	24	25	-1
Moldova	30.5	500.3	25	23	2
GDP-weighted average*					
EE-13	99.3	894.6	1	1	0
CIS-12	54.3	673.2	2	2	0
EE and FSU-25	71.3	760.6	x	x	x

Sources: EBRD 1999 and author's calculation. Preliminary data for 1999 also from PlanEcon 1999a and 1999b, and from available national statistics.

*The weights used are the EBRD estimates of nominal dollar-GDP for 1996.

Figure 3: Index of Aggregated GDP for the Decade 1990-99 (1989=100)



Source: Author's calculation based on data from Table 3.

Who therefore is better off? Is it a country with higher current level of GDP compared against the pre-transition output, though the sum of GDP for the entire transition period is relatively lower than in an alternative case? Or is it a country where the GDP amassed over the whole transition decade is relatively larger than the other country, although the current production is still relatively lower if compared to the other country? It depends. The issue is that from the formal point of view (leaving aside important structural changes), the same category of GDP is concerned. From another point of view, though, the somehow changed society is taken into account. Once again: today's higher income is not always a compensation of yesterday's loss. This is because some other people had lost and some other had gained. Such an outcome may cause social stress and political tensions, making economic policy and the structural reforms that facilitate it more difficult. Thus, what is important in this regard is a fluctuation of the rates of contraction and growth. It seems that what is more favorable is a less hectic and volatile fluctuation of these rates and a smoother process of quantitative change vis-à-vis output.

The differences are not striking, yet they are not negligible either. As for the end of the list, the same group of six countries, i.e., Azerbaijan, Tajikistan, Armenia, Ukraine, Georgia and Moldova (and all these countries belong to the FSU) are closing both rankings, although in a slightly different order. As for the beginning of the list, among the group of first six countries, as many as five are on both lists. While Poland and Slovenia are ranked with the same position, that is the first and the second, respectively, the remaining four countries are occupying only slightly different places.

Obviously, in several cases the position on both lists varies and the differences sometimes are quite significant, which illustrates more hectic changes vis-à-vis the alteration of recession and recovery, on the one hand, and the duration of these particular periods, on the other. In utmost instances, the difference is matching four points in either direction. Thus, Estonia and Lithuania are ranked four places worse on the list according to the amassed GDP for the 1990–99 period than vis-à-vis their 1999 GDP compared to the 1989 GDP. On the contrary, Turkmenistan is positioned four notches lower on the former than on the latter.

The most striking difference is between the two FSU republics. Whereas Estonia—acknowledged always as a leader among this group of transition economies—is followed immediately by Turkmenistan from the perspective of aggregated ten-year GDP (respectively 716 and 697 percent), her position from the perspective of the current GDP flow compared with the 1989 GDP (respectively 75.7 and 51.2 percent) is as many as nine positions higher. Therefore, the advantageous position accomplished through this latter criterion almost vanishes if only the total ten-year output is considered as an alternative criterion. But while looking forward, for obvious reasons Estonia is better, because from now on she may enjoy the growth

stemming from the higher basis, hence bringing also a larger increment of production in absolute terms. In another words, if Estonia's GDP grows now by 10 percent, it makes an increment of about 7.5 percentage points of her 1989 GDP. If Turkmenistan does so, it makes an increment of merely about 5 percentage points.

In total, over the period of last decade, the whole group of twenty-five postsocialist transition economies produced barely 7.6–fold what they were able to produce in 1989. The corresponding index for the CIS stands at 673 percent and for the EE at 895 percent (see Table 5). It means that in Eastern Europe it takes as many as eleven years to produce the GDP matching the 11–fold 1989 GDP. It is the same from a formal viewpoint, as there would not be a recession, but just stagnation lasting eleven subsequent years—from 1990 until 2000.

Hence, such diversified paths of first recession and then recovery, and then growth (and, unfortunately, in some instances then once again recession) are of a unique nature. This is already the past, although transition will continue into the future for a long time. There are some lessons that ought to be learned from the experience of transition up to now, yet as far as the growth policy is concerned, the bygones are more and more the bygones.

At the current stage of transition, this group of emerging markets indeed has more in common with other emerging markets than it had only some years ago. Then it was often believed that these countries were supposed to be tackling similar problems as other distorted regions of global economy, particularly Latin America. That was neither the case then nor it is now, despite growing similarities between structural and institutional challenges that all these countries are facing. Nonetheless, whilewe consider the policy options from the viewpoint of future growth, the specific features of postsocialist economies still must be taken into account very seriously. Of crucial importance here is the process of institution-building.

Chapter Five

Policy Response and the Role of Institution-Building

From an economic perspective, the statist centrally planned system had come to the end because of the lack of ability to adjust. The changing environment of the world economy became a more demanding and thus rigid, inflexible system, enmeshed in numerous distortions, proved to be unable to improve its competitiveness. Whereas on the one hand globalization brought a threat for countries unable to adjust, on the other hand it brought also a chance to overhaul an inefficient system. In addition to growing internationalization of economic links, the ongoing technological progress together with vast political changes were critical catalysts in deciding that the time for comprehensive transition had arrived. Otherwise it would have been difficult (if possible at all) to adjust to growing development challenges and to take advantage of increasing chances for long-term expansion. Therefore, two issues have emerged.

First, initially the policies must tackle these new challenges within the framework of inherited old institutions. The institutions, i.e., the rules and the organizations that help to comply with these rules, always matter in economies in transition to a market system. But, within the wider concept of the meaning of institutions, the market culture and behavioral aspects of market economy ought to be looked at also. Hence, in transition economies—even if the law regulating the rules of an emerging market economy has been already adopted, and even if the organizations assisting the observance of these laws have been established—there is still a challenge of market culture and behavior, which are lagging behind the requirements of a sound market system. This culture is also a function of learning by doing, and it takes time everywhere, including the postsocialist societies. Yet it must be admitted that on a historical scale this process of learning by doing is going reasonably fast.

Second, as time is elapsing, these very institutions must be changed for the purpose of facilitating the policies. While in the long run the quality of institutions, and thus their short-term ability to support the course of actions, is a matter of policy, in the short run time the institutions are given. Hence, the policies carried out must be performed within the limits im-

posed by the existing institutional arrangements. In another words, there were—and to a degree still are—policies that cannot be implemented in transition economies because of institutional weakness. This claim, so obvious at the end of the first decade of postsocialist transition, was not a common wisdom at the onset of it; quite the contrary. Nonetheless, already at the beginning of transition there were also serious warnings pointing to this institutional dimension of the process.[1]

Not surprisingly, weak institutions—either tailored earlier for the needs of the outgoing statist system with the dominance of the government sector and bureaucratic control, or later only emerging from nothing—were also weakening the efficiency of policy. As for the real economic processes, considering such institutional weakness, there were various reactions that should have been expected, yet often they were not anticipated, precisely because of the negligence of institutional arrangements.[2] The most important in this respect was the lack of an early positive supply response. Many policymakers and their advisors, including certain international organizations, expected that the output should start to grow soon after liberalization took place and some critical mass of privatization was executed.

However, despite quite rapid and far-reaching privatization, for a prolonged period of time there was no improvement of allocative efficiency, or—to be more precise—it deteriorated. It would be opaque to assume that it was happening because private assets are less productive than the ones owned by the governments—since they are not less, but more productive—although there was such a coincidence that privatization was followed by the contraction. Thus, sometimes, transitional recession and depression are associated with ongoing privatization, yet it must be mainly linked to the institutional drawback.

Another important observation is that within the same or similar institutional arrangements alternative sorts of policies might be implemented. That means that, regardless of the existing institutional arrangements at a given moment in time, the policies can be better or worse. The policy re-

1. A good example of such warning was, *inter alia,* the following opinion: "The reform of [a] tax system will take place under difficult economic, social, and political conditions. Successful tax reform is never easy, but, given the circumstances, it is likely to be especially difficult in these countries and to take longer than many observers have assumed. In taxation there cannot be a 'big bang' solution since required changes, even when mistakes are avoided, cannot be made overnight. Because of the different environment in which the tax reform will be enacted, there is no certainty that the final outcome will be as good as one would desire." (Tanzi 1991, p. 19).

2. While considering the institutional aspects of transition, Douglass C. North has pointed out that: "Western neo-classical economic theory is devoid of institutions, it is of little help in analyzing the underlying sources of economic performance. It would be little exaggeration to say that, while neo-classical theory is focused on the operation of efficient factor and product markets, few Western economists understand the institutional requirements essential to the creation of such markets since they simply take them for granted." (North 1997, p. 2).

sponse can be more suitable to tackling the issues in one country, or less suitable in another. Therefore, the different policy responses are delivering different results, though the institutions do not differ.

However, it is also possible that even within the framework of weaker institutions the outcomes are better than they might be in places with stronger institutions. And that is exactly the result of better policies. Thus, the institutions do matter, but so do the policies. It may happen that economic performance is healthier in a country with better or worse institutions, or in a country with a better of worse policy. To some extent these are complementary matters, to some extent they may substitute for each other. And this explains why, as far as economic growth is concerned, some countries, *ceteris paribus,* are doing better than others. It also explains why in some of them the performance may be more remarkable over one period and worse during another, despite the fact that in the meantime the institutional arrangements have been upgraded and improved.[3]

Of course, the best combination is to have sound policies and good institutions. And, no doubt, the worst one is to have the opposite, i.e., weak institutions and bad policies. From this perspective, unfortunately, in transition economies the latter alliance has happened more often than the former. So, not surprisingly the transitional recession became the Great Transitional Depression.

There is not any clear rule with respect to the combination of quality of institutions and quality of policies in early transition economies. Later, presumably, they start to facilitate each other vigorously. However, before that occurs, it may happen that relatively better institutions can demobilize the lawmakers and the policymakers from taking committed care of further structural reforms and continuing institution-building, since it is an everlasting process and not an episode. Or it may happen to go the other way around. Then the distortions, difficulties, tensions, crises, etc. are pushing the governments to reform the institutional orders still further. In short, although of great economic implications, this question is also of a great political nature. The answer to it depends on the ability of the elite to formulate the long-term development visions and is strongly involved in a feedback with the simultaneous process of political liberalization, i.e., democratization.

3. A fine example of this inter-relation is the Polish economy. In this country, due to gradual yet committed institutional building and because of sound policy, growth had accelerated after 1993, following the recovery that started in mid-1992. However later, since after 1997, the pace of growth did slow down significantly (and much more than expected). It had occurred despite ongoing advancement of institutional building over all these years as well as before and afterwards. To modest extent it was provoked by the external shocks, by mainly was caused by the deterioration of policy. The analysis just pointing to the external shocks falls short to explain the drop of the rate of GDP growth from as much as 6.7 percent in 1995–97 to only about 4.4 percent in 1998–99 and then to as low as 2.7 percent in 2000–01. The deterioration of policy does explain it.

Hence, the issues are quite complex. It is excellent when the progress with institution-building results simply from the wisdom of the people and the determination of their leaders. It happens. But experience shows too that quite often the institution-building gains momentum if the problems are mounting. Then a strong pressure appears and a need for structural reforms, coming especially from the emerging business sector, but also from the outside, increases. The international organizations—which provide technical and financial assistance based on the condition that a proper policy is executed and adequate reforms are put forward—contribute as well to such processes.

Chapter Six

Market Imperfections and the New Role of Government

As the debate continues about the policies that should be used to shift from state socialism to the market economy and from stabilization to growth, it has become the generally accepted opinion—if not a truism—that none of this can happen without proper government engagement (Fischer, Sahay, and Vegh 1995). Even extreme neoliberal zealots in government—not at all a rare occurrence in Eastern Europe—exercise vast amounts of interventionism.[1] The laissez-faire ideology remains where it belongs, in the world of words, in the sphere of ideas and illusions. In the world of real politics and true policymaking, laissez-faire is not and cannot be a viable approach. The work of the market is being seconded by the active policies of government in financial, economic, and social matters (Kolodko 1998).

Though arguing appropriately in favor of the market, some authors stress that until not so long ago government intervention played a very positive role in development. State control of the economy worked well for a long while in traditional capitalist countries. In reference to the statist policies adopted after the Second World War, Yergin and Stanislaw (1998, 128) ask,

> 'Who could deny the success of the experiment? From the end of the Second World War until the oil crisis of the 1970s, the industrial world enjoyed three decades of prosperity and rising incomes that sparked aspiration and dreams. It was an extraordinary achievement.'

And then they reach the conclusion (p. 129) that,

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1. Some observers believe that the declared 'neoliberals' in Hungary and Poland, having already been taught by the experience of the early 1990s how the economy really works, are eager now to intervene in the market even more than the 'leftist' governments did (the leftists presumably having hesitated because they wished to prove that they were not 'postcommunists'). Though this is not true, the fact is that, whereas the gap between the words of the 'neoliberals' and the 'leftists' is like the Grand Canyon, the gap between their deeds is like a little ditch. Such pragmatism is a good sign for those who hope for the success of the transition.

> 'By the end of the troubled 1970s, a new realization had gained ground: More than daily management, it was the entire structure of the economy that had reached its limits. It was imperative to rethink government's role in the marketplace.'

If indeed the issue was the simple one of reaching the limits, then it is puzzling that almost the entire globe turned away from statism at almost the same moment, since at the time nations were at such varying stages of development.[2] But the world was also turning away from other old habits around them. Why? Simply because one must follow the leader. When changes are being undertaken in countries that are leading the course of events, soon afterwards they can (or must) be carried out elsewhere. If a step has already been accepted and executed by a leader, then it is much easier to push the case for such a step elsewhere. This is even more true in the midst of a vast process of globalization that is reaching well beyond economic and financial affairs alone. Thus, since a leader is getting rid of some old habits, during a period of globalization the old habits are being got rid of on a global scale. It is only a matter of time.

Of course, there is a world leadership, as well as local ones. The United States has unquestionably been leading the world since the end of the cold war, but there are also regional leaders taking steps that deserve to be followed. The social security reform implemented in Chile is catching on throughout South America. The way Poland has managed the transition is a model in Eastern Europe. Uganda is trying to find the path toward fast growth in Central Africa. The industrial policy of Singapore has imitators in East Asia.

If the impact of what is going on in the most advanced market economies is not always directly felt in the economies going through structural adjustment, then it is certainly very often felt indirectly. The best way to bring democracy and an open market economy to Paraguay is probably to do it via Chile, to Myanmar via Thailand, and to Belarus via Poland. This is well understood among world leaders, including the potential partners in the post-Washington consensus.

Aside from the geopolitical dimension, in trying to answer the important questions, one must take the historical perspective, too. For example, the United States has come to terms with the acknowledgment of the existence of minority rights quite late. Only a generation ago in some states there were still schools and other public institutions (including restaurants and public restrooms) 'for whites only'. So, the 1960s were not the best years for the US to complain and moralize about the civil rights of blacks in

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2. This is also true of the former socialist economies. Hidden within the 'multi-republic' Soviet Union and the Yugoslav Federation were countries like Tajikistan with GDP per capita below $1,000 and countries like Slovenia with GDP per capita at 5 times that much.

South Africa or about the treatment of the Hungarian ethnic minority in Czechoslovakia. On another topic, Joseph E. Stiglitz (1998b, 70) writes that,

> 'It is hard to escape the irony between early drug wars—Western powers trying to keep China open to the flow of drugs—and the more recent equally adamant stands [of the Western powers] trying to stem the flow of drugs into their own countries. Only the lapse of time—and lack of knowledge of these historical experiences—softens what otherwise seem[s] an intolerable level of hypocrisy.'

Yet the hypocrisy is still there, even without the difference in historical time zones.

After years of insistence on trade liberalization, the U.S. House of Representatives—when a majority of emerging market countries in Latin America has finally accepted the idea and got keen to apply it—has denied the president the power to take the fast track in trade, and so trade has not turned out to be as free as the market zealots themselves have said it should be. Once more, it is a good idea to distinguish between the ideas and the words, the interests and the deeds.

And it is good to remember that hypocrisy exists, and that unfortunately it does matter in politics and politically motivated economic debates. In the real political world, including the international one, it so happens that the stronger partners really seem to expect the adage 'do what I say, not what I do' to be followed. If only what some are advising others to do were also being done by the advice-givers in their own countries, many problems would look quite different. For example, an upward adjustment of energy prices in the United States through the imposition of a special excise tax would have led to a decrease in the fiscal deficit several years ago. Likewise, if the advisers would only follow their own advice the EU bureaucracy in charge of agriculture policy would now be several times smaller than it actually is. Instead, today the energy prices in the United States are lower and the agriculture subsidies in Western Europe are higher than those in Eastern Europe.

When (or perhaps the question ought to be introduced by 'why') should one retreat from statism? It might be argued that the 'when' has arrived already, since the leaders of the global economy have already so decided and acted (albeit only to a degree). And they, for sure, know what they are doing and why. However, if state control has reached its limits in the advanced market economies (which is not certain), this is not necessarily the case in transition economies or in less-developed economies. Even at a time of deep structural crisis in Japan, one of the most developed countries, the most extreme of the neoliberal extremists have not expected markets to fix the problem, but have called on the government to do so.

In general, the state may retire from intervention in the economy when market mechanisms, market culture and behavior, and proper institutional arrangements exist to carry out the functions it performs. There seem to be two criteria for the withdrawal (never complete) of the state from intervention in the economy. First, there must be a reliable mechanism to sustain long-run growth that is impervious to minor external shocks. Second, if there is nonetheless a crisis because of an unfortunate coincidence of external shocks, then there must be an automatic mechanism that corrects distortions so that the economy can remain on track toward development. Even in the most advanced market nations, including Germany and the United States, these criteria are not met.

If the involvement of the state in economic matters was justified in the past in the development of the countries that are currently most advanced, it is at least equally well justified in countries currently lagging behind with respect to development and market sophistication. There may be good arguments for significantly less government intervention in the economy in Belgium and Italy today, but they do not necessarily apply in, say, Bulgaria or FYR Macedonia. What may be reasonable in the United States under President Bush may be irresponsible in Russia under President Putin. Even what is now feasible in Hungary and Poland should not be attempted yet in Kazakhstan or Ukraine because of the institutional gap among these emerging market economies.

If the transition to the market is to succeed, governments must be energetic in a number of areas of the economy. Governments in the postsocialist nations must intervene to manage transition policy and development strategy so that production can start to increase. Active government intervention is especially required to steer the economy toward recovery, but it is needed to achieve sustainable growth, too. Government policy engagement must be maintained even when the economy is expanding, because nowhere—and this is particularly true during transition—is economic growth a given. It must be supported and managed. To sustain rapid growth—if it is to contribute to equity and not harm the environment—may demand even much more policy attention than the early stages of liberalization and stabilization. During the later stages of transition, in the aftermath of the postsocialist crisis, even more government involvement may be justified. When liberalization and stabilization are the priorities, the 'invisible hand' of the market can be relied upon more, but during the shift from stabilization to sustainable, environmentally friendly, and equitable development the 'visible hand' of the policymaker has more to do.

Few people like to go to the dentist, but the dentist is essential if we wish to monitor the health of our teeth properly. The dentist reduces the risks by cleaning, filling cavities, and sometimes doing a little drilling. But we would be wise to choose our dentist carefully. Likewise, if the government putters with the market, it may augment the distortions, but by intervening wisely it can prevent crisis. The government can inadvertently boost the effect of

the imperfections in the market, or it can counteract them to enhance the strengths of the market.

Even in contemporary liberalized economies, governments and markets must complement each other.[3] There is all the more reason why this should be so in postsocialist economies, where automatic mechanisms have not yet evolved sufficiently to enhance the institutional arrangements on which the market must depend if it is to function efficiently and contribute to the welfare of the nation.

Market imperfections, as well as governments, can cause serious economic problems and foster crisis. The expansion of the role of government is not a sure remedy for market imperfections, nor is the extensive liberalization of the market a sure remedy for the failures of government. The cure-all is a 'partnership' between the market and the policymaker. What is needed to mend market imperfections is not less market and more government, but a better and stronger relationship between the market and the government.

The collapse of state socialism was a result of the failure of the state for the simple reason that under state socialism there was no market. The Great Depression of 1929–33 was caused by the failure of both the market and the state. The Great Transitional Depression of 1990–99 in postsocialist countries was likewise due to the fact that neither the state nor the market was able to clean up the mess. Now, in the aftermath of this depression, neither the state alone nor the market alone is going to be able to achieve recovery and sustainable growth. The transition is thus an ongoing search for the proper mix of market and government.

The market must evolve, and the government must assist in the process, but as the market evolves, so must the role of the government. Only a combination of these two regulatory systems, the one led by the market and the other by the state, will be able to deliver sound supply responses. Market institutions must be designed by the state and then allowed to evolve in such a way that they promote efficiency and competitiveness. Meanwhile, as the market evolves, the state must redesign its interventions to correct market imperfections and assure equity and long-term development. Only coordination between these two processes can secure increased capital formation and growth.

The danger of too-thoroughgoing government interventionism is especially high at the early stage of transition, when the burden of old policy instruments and weak institutions is greatest. The neoliberal solution is the withdrawal of government ('the best policy is no policy'). But then there is also no growth, or, if there is growth, it is sluggish, unsustainable, and inequitable. Some segments of society benefit, but most people suffer more. Thus, the non-approach of 'the best policy is no policy' has been compromised (and not only in transition economies).

3. Obviously, the debate on this issue is far from over. For example, see World Bank 1997b.

The constructive solution is a new style of engagement of the state, not the withdrawal of the state. A convincing argument in favor of this approach has already been provided through the experience of a number of growing economies, including reformed socialist economies and transition economies. The approach represents a foundation for the post-Washington consensus, and this is very important, for it can affect economic policies worldwide. Indeed, almost the entire globe is turning away from the neoliberal bias and seeking a new role for the state, and the effort would have a better chance of paying off in Myanmar, Paraguay, or Belarus if it were well understood elsewhere, for instance among the potential partners of the post-Washington consensus.

The fact is that the contemporary world is so complicated because there are so many global links, and national economies need government-led policies and government intervention more than ever. Yet, the involvement must be of a different sort, especially in postsocialist countries. The core of the transition process is a liberalization that releases spontaneous market forces, but this should be matched by an effort to establish sound financial fundamentals, develop infrastructure, secure investments in human capital, introduce necessary structural reforms, and set new institutional arrangements. This effort should be serious enough that the state seeks to restructure its interventions in the economy, not eliminate them.

In industrial nations the share of public spending in GDP jumped from about 12 percent in 1913 and 18 percent in 1920 to 28 percent in 1960 and 45 percent in 1990. There were several reasons for this phenomenon, but it would not have occurred if there had not been strong and constant political pressure and a good economic rationale for so much public expenditure. In part, it was also due to an evolution in social values, especially the growing conviction that development must be equitable and that the market system was unable to guarantee this equitability. The expansion seemed to be justified by traditional needs such as defense, infrastructure, and administration, but also by the widespread belief that only the state can furnish adequate education, health care, and social security for all. So, the new state and 'big' government emerged.

The insistence on an expansion in government spending can be reexamined only at a higher stage of development, when there are sufficient private resources to ensure that the requirements in education, health care, and social security can be reasonably met, and when the institutions exist to manage these resources without direct state participation. The recent drive in advanced market countries to alter the decades-old tendency toward ever bigger government can be explained by the fact that they possess a positive alternative. Indeed, it may be necessary to contain or downsize big government for the sake of competitiveness, capital formation, and growth potential.

The situation is not the same in transition economies, and the same considerations are therefore not necessarily justified. The postsocialist nations are poorer, and their level of development is far from adequate. While the more advanced and the relatively rich among them have somewhat more resources, even these do not have private institutions able to provide the services only the state has supplied so far.

Because of the long experience in some regions it is being realized that development also depends on the 'visible hand' of the government rather than exclusively on the 'invisible hand' of market forces. In the mid-1960s the level of development was similar in Africa and East Asia. In 1990 Africa was still backward, but East Asia was 'newly industrialized'. Without appropriate state involvement and government policy backing, market forces in Africa have not been able to deliver durable growth. Paradoxically, the late 1990s Asian crisis, manageable neither exclusively by market forces nor only by governments, is another argument in support of the claim that even at the *fin de millénaire* there is room for more and better government engagement, but not for government retirement.

The active role of the state must be redefined, not abandoned, during systemic transformation, whether the reform of a socialist regime or the postsocialist transition. The process of privatization demands a different type of partnership between government and the private sector. The new circumstances call for a fresh regulatory environment, not only 'deregulation', but 're-regulation'. The government must take on the burden of a proper policy to encourage competition. It must fight monopolies. Even if just for this one cause, the old state may not be needed anymore, but the new one is very much required, at least until the competitive environment is established and efficient product markets appear.

During transition the state changes the scope of its activities and also the instruments it uses to implement its chosen strategies.

> 'The market itself cannot deliver broad-based improvements in the standard of living without an active state which establishes the right conditions, responds to change, and which, together with the market, provides for the delivery of health, education, infrastructure, and social protection, which the market cannot provide by itself. The way in which the role of [the] state is defined, and in which services are delivered, is probably the most important determinant of the standard of living of the community over the long-run term.' (Stern and Stiglitz 1997, 27)

These are still more important reasons because they are here being listed by the former and the new chief economists of the World Bank, and a successful shift from depression to recovery to sustained growth in the transition economies depends to a considerable extent on the financial and tech-

nical assistance of these and other financial organizations, mainly the International Monetary Fund and the European Bank for Reconstruction and Development.

The world is so very diverse that it is quite strange that there is a tendency to draw general conclusions and give advice that is supposed to meet all challenges. What works in some circumstances is not necessarily appropriate in other circumstances. One size does not fit all. This is as true of shoes and socks as it is of the level of involvement of the state in managing recovery after a crisis. If the downturn in the business cycle in an advanced market economy is of the normal variety, then of course market forces and the government should react normally. But if there is long-lasting depression and extensive structural crisis, then a 'new deal' in government economic policy and in institutional responses may be required. This is true not only of the postsocialist transition and development, but also of the serious economic challenges being faced elsewhere in the world. The 'new state' is as much needed in Africa as it is East Asia.

According to the World Bank (1997b), there are five crucial functions that should be fulfilled by the state because the market and private institutions cannot perform them. These functions are related to legal foundations; the macroeconomic policy framework; investments in basic social services, in human capital, and in infrastructure; the comprehensive safety net for the vulnerable in society; and the protection of the natural environment.

The problem is that these five key functions are policy declarations or policy directives rather than conditions that are respected in the advice of international financial organizations and in the policies being executed in developing and transition economies. They have not really become performance criteria, and thus they are not considered so decisive in actual policy packages. Yet, financial and technical assistance would do well to focus greater attention on these five functions, which ought to be performed by the modern state in an emerging market economy.

Furthermore, lending by the World Bank and the EBRD should be based much more on conditionalities that recognize these five key domains of state activity and should definitely not support policies or programmes that may weaken or ignore them. This calls for a revision of the qualification procedures for financial assistance and especially a revision of the method of monitoring the countries being provided with lending by international organizations, so that much more serious attention is paid to the fulfillment of these five essential state functions.

However, for the sake of fiscal prudence and monetary stability, policies that disregard these functions are being supported, too, especially stabilization and structural adjustment measures which, unfortunately, often lead to falling output and growing inequality and thus to spreading poverty,

rising unemployment, divestment in human capital, a frazzling safety net, and weaker environmental standards.

There are contradictions between the means and the ends of policies, and there are thus also contradictions among the excessively numerous priorities on the agenda. So, the World Bank postulates firm financial reasons for one course of action, but these turn out to be secondary in the confrontation with the IMF over sound financial fundamentals.

Despite the significant structural and institutional changes of the 1990s, the redefined functions of the new state in transition economies are all quite similar. But 'similar' does not mean 'identical'.

Chapter Seven

Small versus Big Government and the Quest for Equitable Growth

It is often claimed that the shortest way to recovery and growth following transitional contraction is to diminish the role of the state. As proof of this, mainstream neoclassical economists cite a few carefully selected examples of successful nations with small governments and fast growth. However, in light of experiences in the world economy, the supposed alternative between big government and a lower rate of growth or small government and a higher rate of growth does not really seem to be an entirely valid one. If there were such a clear choice, then small government might be a better option, even at the cost of a temporary dropoff in public services. In fact, in the real world, such a solution may sometimes be appropriate, but the opposite situation is more likely to emerge: a positive correlation between the size of government and the pace of growth.

In transition countries, 'small government', that is, a relatively lower amount of income redistribution through the public finance system and the relatively minor involvement of the state and the public bureaucracy in economic affairs, usually means that institutions are weaker and that the shadow economy is larger. Meanwhile, 'big government' means that the state is more active and redistributes a relatively larger chunk of income through the government budget.

Government expenditure can accelerate the pace of growth, particularly if it is directed at institution-building, the upgrading of infrastructure, and human capital investment, especially education, health care, and research and development. Government expenditure can hinder growth if the bulk of state expenditures flows toward the bureaucracy, defense, and subsidies for non-competitive activities. In short, outlays can be productive or nonproductive, investments can be oriented toward the future or toward current consumption, and expenditures can be well targeted or miss the target. The trick is to determine the proper mix between management by the state and management by the market.

Orthodox neoliberal economics suggests that a reduction in the size of government facilitates growth. However, during the early transition something quite different happened. Owing to the complexity of the changes, it is not possible to identify exactly the nature of the correlation, but there

can be no doubt that during the early transition there was a causal relationship between the rapid shrinkage in the size of government and the significant fall in output. The sudden withdrawal of subsidies caused a financial squeeze, and the radical stabilization measures led to a credit crunch. The initial shocks were thus followed by recession. Only later, after output is back on the path of growth, can the positive effects of the pruning in government be seen, if indeed they occur, for this depends more on the quality of development policy than on the pace and scope of the decrease in government expenditure.

Consequently, even if to some extent under certain conditions it may be true that smaller government can foster long-term growth, the issue is not really whether less government is better, but how to get from here to there and how long is ‘long-term’. Is it 15 years or 50? This is at least as important here as it is in a marriage. The challenge in transition economies is not the overall paring of government expenditures, but a change in the structure of government expenditures so that a greater portion of outlays contributes to faster growth and fairer income distribution.

It is almost impossible to prove that public services are more effective if there are fewer of them (that is, when government is smaller), but the attempt is still being made (*The Economist* 1997). However, it is clear that the various components of government expenditure change during transition. Since the type of government is new, with new targets and instruments, new friends and enemies, and, especially, new sets of problems, expenditures in some areas must climb, but in others they decline. Nonetheless, an across-the-board reduction in the size of government by reining in expenditures, often those directed at infrastructure and human capital investments, can erode not only current levels of consumption and living standards, but also growth and the standard of living in the future. The belief that there is a strong inverse correlation between the size of government and the rate of economic growth can thus exert pressure for spending decreases that are too far-reaching not only in countries with unsustainable fiscal deficits, such as Russia and Ukraine, but also in those with a sound fiscal position, such as the Czech Republic and Hungary.

Analogous conclusions about the danger of excessive curbs on government expenditure have been derived from an extensive study conducted on the issue of humanitarian emergencies in a sample of 124 developing nations by the World Institute for Development Economics Research (WIDER). The number of such emergencies rose from 20 to 25 per year in the early 1990s to 65 to 70 more recently.[1] ‘External pressure by the World Bank,

1. Among transition economies there have been humanitarian emergencies in Armenia and Azerbaijan (due to the conflict over Nagorny Karabakh), Bosnia-Herzegovina, Cambodia, Georgia (due to the conflict over Abkhazia), and most recently in Albania and the Yugoslav province of Kosovo.

International Monetary Fund, and Western donors to cut the size of the state in order to encourage economic stability in practice triggered increased competition for governmental resources and ended up contributing to greater instability' (Nafziger 1998).

During the early transition, the share of GDP redistributed through the government budget dropped by 3 to 5 percentage points. This means that the participation of the state and its institutions in the absorption of national income diminished by a factor of about one-tenth and in some cases even more.

At the end of the cold war, simply due to plummeting defense outlays, the share of public expenditure in GDP was slashed. This represented a very healthy form of government downsizing. Of the twenty-eight countries involved in postsocialist transformations, only in one, Croatia, was defense expenditure increased, while in half it fell by about 10 percentage points.[2]

The absolute and relative declines in defense spending and in subsidies, another major area of reduction, were one-time measures and cannot be repeated. They were executed in a radical manner, and this caused substantial modifications within the structure of public expenditures in a very short time. Meanwhile, the portion of public expenditures going for human capital and infrastructure investment rose, though the absolute level dropped significantly here, too. Whereas in 1991 military expenditures still exceeded combined education and health disbursements by 14 percent in China and by 32 percent in Russia, now these states invest more in human capital than they do in unproductive armaments.[3] The relatively low military expenditures in China and Russia reflect a clear policy choice: defense has been subordinated to the reforms and to transition.[4] This is indeed an important shift in the pattern of income distribution through taxation and government spending. In the contemporary world there is no analogy for such a tremendous GDP redistribution in peacetime.

Yet, these quickly shrinking items (in absolute terms) on the expenditure side of the public finance balance sheet have been replaced by other quickly climbing items. A special burden is being imposed by the mushrooming costs of social security. The burst in unemployment and the mounting outlays to support the pension system are taking their toll. To maintain or curtail the relatively high levels of government spending is hardly a policy

2. They certainly rose also in Bosnia-Herzegovina and Yugoslavia, which are not included in this accounting.

3. By comparison, in the same year military expenditure exceeded combined education and health care disbursements in Israel by 6%, in Pakistan by 25%, and in Iraq by 171% (UNDP 1997).

4. In the case of China, rapidly growing income means that there has been more flexibility in identifying spending priorities. In Russia the collapse of fiscal revenue has forced military expenditures downward, so that the 'choice' has been more like an economic constraint.

possibility as long as the reform of social security systems has not been completed. Only when an alternative method of financing pensions is in place can additional thinning out in overall government expenditures be considered. This will not be for quite some time.

Meanwhile, the public provision for social security will not only remain high, but must grow. Populations in the postsocialist countries are ageing. The share of people over 60 is expected to exceed 25 percent by 2030 (IMF 1998). However, by that time, pensions will no longer be financed through the old pay-as-you-go public systems, so relative government spending will have had (perhaps) an opportunity to diminish.

Government expenditures can also be trimmed across the board without so much attention to the composition and structure of the reductions, especially if the need is urgent or the external pressure is great. Often overlooked in such a situation is the lack of services or funding sources to replace those eliminated because of the cuts. What has so far been provided by the state through the budget is now supposed to be supplied by the private sector through market allocation. This is a very difficult part of the transition exercise, and through it the importance of the coordination between transition policy and development strategy can be clearly seen (Kolodko 2000c).

Only in a growing economy do households have a chance of finding alternatives to these services, and then only if they have enough income. To change the system is therefore only feasible if the economy is expanding; it is ill advised to push through the relevant structural reforms at a time when their implementation will lead to a deterioration in living standards.

A study prepared at the World Bank (Commander, Davoodi, and Lee 1996) finds that a country with a proper combination of small government and good institutions may be able to double GDP in about two decades, but that a country with a bad combination of big government and poor institutions would need two and a half centuries to accomplish the same thing. This sounds impressive, but it looks more like mumbo-jumbo than economics. Fortunately, no modern nation anywhere anytime has needed 250 years to double its GDP, and this is not going to happen in any of the transition economies either. Anyway, the transition is not going to last that long, so there will be no chance to run the experiment. Even if the relative size of their governments is bigger than that of some of the most advanced market countries, the leading transition economies may be able to double their output in a matter of just one decade.[5]

What the study does point to correctly is the strong correlation between the rate of growth on the one hand and, on the other, the size of government and the appropriateness of institutional arrangements. The unfavor-

5. This is what the World Bank envisages in another forecast (World Bank 1997c). If a transition economy is able to enjoy a 7% GDP growth rate over two decades, this would not be a doubling in output, but would represent a growth of nearly four times over the 20 years.

able combination of big government and low-quality institutions is a serious threat in postsocialist economies, as it is in several less-developed market economies. Such a combination favors ill-advised interventions of the weak state bureaucracy in market affairs. This may lead to improper allocations of public expenditure. It can also delay the adoption of new laws and needed market regulations.[6] It can fuel corruption, which takes resources away from the official economy.

Regulations which are transparent—especially vis-à-vis financial and capital markets, banking, privatization, and public-sector procurements—should be introduced and enforced as soon as this is feasible. The implementation of effective regulatory measures requires the sound commitment of the government. It also calls for a strong, not a weak state, and such a state must have already been redefined and redesigned.

It may be that at least part of the debate about the role of the state stems from a confusion between small and big government on the one hand and strong and weak government on the other. A lot of the confusion—if it exists—may be due to a false supposition that 'big' means 'inefficient' and that 'small' means 'efficient'. In fact, for instance, Turkmenistan has a big, strong government, which, however, is not very efficient. Meanwhile, Croatia also has a big, strong government, but it happens to be rather efficient. Whereas Latvia has a small, strong, and efficient government, Albania has a small, weak, and inefficient one.[7]

The best (worst) example is Russia in the 1990s, with its informal institutions and very poor regulatory framework. From time to time the government makes very serious attempts to push through sound structural reform, but the attempts quickly fail. The problem seems to be not that the government is too big, but that there are too many of them. There is a lack of transparency. What is the role of the government? What is the responsibility of the Kremlin, that is, the President's Office? What is the attitude of the parliamentary majority toward the executive branch? What indeed is the position of the informal institutions (starting with the financial and industrial 'tycoons' and the news organizations they seem to control), which often behave as though they were another government?

In short, the government must first be strong enough to carry out its new role, and this ability is not a simple function of its size. The real choice is

6. Catch-22–type situations sometimes arise. In Ukraine in 1998 a budget amendment could not be adopted until the summer, although it was a crucial provision required for numerous structural reforms. This occurred not because of any inability to obtain the support of a majority for the reforms or the budget amendment, but because parliament could not agree on a speaker. It failed to chose one in eleven attempts: very democratic, but very counterproductive.

7. From a purely mathematical viewpoint, leaving aside any nuances or subtleties in terms of the specific conditions within countries, there are eight possible combinations of the words 'big' or 'small' government, 'strong' or 'weak' government, and 'efficiency' or 'inefficiency'.

between the kind of regulations and the range of budgetary redistribution in efficient countries, like Hungary or Slovenia, and those in inefficient countries, like Belarus or Romania. Hungary and Slovenia have shown that, even if they do not have small governments, they do have experience, good institutions, and wise policies, and they have enjoyed good overall economic performance and an early recovery. Thus, the main challenge for the nations lagging behind in growth and development is not a reduction in the size of government, but the need to overhaul government and put it in order. This may call for downsizing, or it may not. A government can be too big, or it can be too small, but it can never be too good.

The issue is not the need to decrease state expenditures, but the need to improve the allocation and efficiency of these expenditures.[8] In several nations, because of the resistance of the government bureaucracy, financing for schools and health care has been pared instead of controlling the excessive outlays for the bureaucracy. In many cases, crusades aiming at containing the size of the bureaucracy have ended up by containing only the number of teachers and doctors or adding to the arrears in salaries owed to teachers and doctors. The impact of such policies on growth and equity must be taken very seriously.

If the public finance system needs reform, this should be accomplished in a way that contributes both to growth and to equity. If the approach favors growth over equity or equity over growth, then we are back with the debate between liberalism and populism, and we already know that both these adversaries are wrong. If the government curbs its expenditures and its revenues simultaneously, then it is downgrading its financial effort to meet the needs of some parts of the population while boosting the net incomes of other parts of the population. So, the public finance system is redistributing resources from some individuals and groups to others.

Basically, this is a redistribution by the state to the private sector with as many implications as the number and kinds of services being affected. It might help movie theatres, but it might fail to improve health care. It may do no harm to the circulation of newspapers, but lead to the elimination of symphony orchestras. It may be justified vis-à-vis reduced support for postgraduate university studies, but it may not be justified in terms of the fall in secondary school enrolments. Perhaps postgraduate university studies can and should seek to survive without state help, but secondary school enroll-

8. The belief which says that the remedy lies in lower expenditures dies hard. 'The IMF will press Kiev to slash some 1,000 tax exemptions as a key condition for handing over the loan to the cash-strapped government. . . . [T]he Fund has also asked the government to cut planned expenditures in the remaining half of the year by 30 per cent, or $2.1 billion' (*Development News* 1998). However, even in a situation of robust growth and healthy performance, it is extremely difficult to reduce expenditures by such a huge margin; to require this in such wretched circumstances is simply unrealistic.

ments will be able to rise again only after long and painful adjustments in education at the expense of the future.

If such policies are applied, perhaps the private sector will be able to expand more quickly, but those groups will suffer that cannot now afford to pay for the services that used to cost so little when they were provided by 'big' government. Hence, even before output has started to grow, inequity has already risen a great deal. The roots and the fruits of this sort of redistributive policy, undertaken merely because of a curbstone opinion about the role and the size of the state, represent serious political challenges, not strictly economic and financial issues.

If a 'big' government economy is defined as one with public spending exceeding half of GDP (like Belgium, Italy, the Netherlands, Norway, and Sweden), and a 'small' government economy is defined as one with public spending below one-third of GDP (like Australia, Japan, Switzerland, and the United States), then the two possess similar characteristics. In 1997, the per capita output (adjusted for purchasing power parity, PPP) in the five former nations was over $21,000 and in the latter four nations around $23,000. The average annual rate of growth in 1960–95 in both cases was almost identical, equal to about 2.5 percent. Gross fixed capital formation is also about the same, that is, 20.5 percent and 20.7 percent of GDP, respectively. The rate of inflation does not differ by much and from 1986 to 1994 was at 3.9 percent in the first group and 3.7 percent in the second. Life expectancy at birth is 78 years in the former and 77.8 years in the latter. The respective infant mortality rates are 6.7 and 6.4 per 1,000 live births. The secondary school enrollment rate is 92.8 percent in the big government sample and 89 percent in the small government sample.[9] According to the composite school-enrollment ratio calculated by the UNDP, the weighted share of children of various ages attending schools in the former is 85 percent and in the latter 82 percent. Illiteracy rates are similarly low in both groups.

With respect to the quality of human capital and the standard of living, the admittedly minor distinctions seem generally to favor the big governments. However, what really seems to distinguish these two groups of economies is not GDP level or rate of growth, but income distribution. The bigger the government, the more equitable seems to be income distribution, and the smaller the government, the larger the share of the income distribution goes to the richer part of the population. The debate therefore seems once again to be more about different interests rather than different theoretical concepts. The claim that small government is efficient government is

9. The infant mortality and secondary school enrolment rates for countries with 'small' government refer to nations in which public expenditures are below 40% of GDP. This sample clearly includes the countries mentioned above (Australia, Japan, Switzerland, and the United States), but is not necessarily limited to them.

not only an abstract intellectual argument, but it protects the interests of favored income groups, too. This last may even be the real aim of policies designed on the basis of the inaccurate statement that small governments better satisfy social needs and serve economic welfare. They satisfy social needs and serve economic welfare, but often mainly the needs and the welfare of the privileged in society.

The two poorest quintiles of the population receive 24.1 percent of the income distribution in countries with big governments, but 20.8 percent in countries with small governments (Tanzi and Schuknecht 1995, Tanzi 1997). In countries with small governments the most affluent quintile receives approximately 44 percent of the income, while the poorest quintile takes in only a little more than 5 per cent. At the other end of the spectrum, in countries with big governments the richest quintile gains about 37 percent of total income, while the poorest quintile gets 7.4 per cent. Thus, in countries with small governments the ratio of the income of the richest quintile relative to the income of the poorest quintile is approximately 8.3, while in countries with big governments it is about 5. That does make a difference.

There would be nothing wrong with these various ratios if they more or less reflected the contribution of the quintiles to a nation's wealth. But this is by no means clear, since the significant expansion in income dispersion in recent decades is the result of an unfair distribution and does not necessarily reflect the real value of the human capital involved.[10] Even this might somehow be acceptable, if the inequalities enhanced the ability of an economy to grow over the long term. However, the words of neoliberals notwithstanding, it does not work this way. The truth is that, whether they have big governments or small governments, the sample countries are growing at similar average rates. Thus, in terms of equity and in a context of growth-oriented policies, the best combination seems to be not small government and good institutions, but big government and good institutions.

In fact, big or small, the only really 'good' government is a capable government that can assure robust economic growth and a fair distribution of the results. There are examples of countries in which government involvement in economic and social affairs is relatively substantial and in which the quality of life is more favorable than it is in countries with less government intervention in these areas (Alesina 1998). This depends mainly on the structure of government consumption and is therefore essentially a function of the policies chosen. For instance, although Vietnam shows a lower level of income per capita than does Nigeria and has a relatively bigger

10. Inequality is growing internationally, too. Similar to the situation within countries, this does not reflect actual changes in the contribution of nations to global wealth, but results from the redistribution of income, this time on an international scale. Worldwide the ratio of the income received by the richest quintile relative to that of the poorest quintile jumped from an already unseemly 30 to 1 in 1960 to a shocking 59 to 1 in 1989 (UNDP 1992).

government, life expectancy at birth in Vietnam is 15 years longer, the chance of children surviving to the age of 5 is two times higher, and the illiteracy rate is two times less.[11]

Not surprisingly, whereas the human development index (HDI)[12] for Vietnam is 0.557, with GDP per capita at $1,208 (in PPP terms), the Nigerian HDI is 0.393, with GDP per capita at $1,351 (PPP). Consequently, the HDI rank minus the rank according to GDP per capita (PPP dollars) is 26 in Vietnam and 1 in Nigeria. China has a GDP per capita at only half the level in Brazil ($2,604 and $5,362, PPP, respectively), but life expectancy at birth is four years longer in China. The relevant differences between the HDI and GDP ranks are 3 and 0, respectively (UNDP 1997). This is so simply because countries like Vietnam and China spend relatively more via the public finance system on human capital than do other countries at similar levels of development.

Thus, the size of government should be a function of the purposes the government serves, not merely a function of general 'rules' which may identify what is better and what is worse regardless of complex local economic concerns and social reasoning. The size of government evolves according to many factors which tend in several directions at once. In fact, the composition of government spending itself reflects the development process in a complicated way. It may happen that big government is sometimes better for growth and development, or that small government is in some cases more appropriate for these purposes. In some nations, big government may turn out to be unsustainable because it is too costly, and it may have to be downsized only for this reason, even if the downsizing slows growth for a while. It may be that, even if a smaller (or bigger) government would under some circumstances promote faster and more equitable growth, an attempt at enlarging (or downsizing) it appreciably in the wrong manner and at the wrong time may cripple performance and thus harm equity and growth.

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11. Data refer to 1995 (World Bank 1995d).

12. The human development index (HDI) calculated by the United Nations Development Programme seems to be a more relevant measure of improvement in society than is GDP, although, in general, over the long run there is a strong positive correlation between the level of GDP per capita and changes in the HDI (UNDP 1997, World Bank 1997a, Ravallion 1997). The HDI is a composite indicator and takes into consideration accomplishments in areas of basic human capability such as life expectancy at birth, educational attainment, and income. Hence the HDI is a more suitable measure of change vis-à-vis the ultimate target of development policy. The HDI is described by the UNDP (1997, 44) as follows:

> 'The HDI value for each country indicates how far the country has to go to attain certain defined goals: an average life span of 85 years, access to education for all, and a decent standard of living. The HDI reduces all three basic indicators to a common measuring rod by measuring achievement in each as the relative distance from the desirable goal. The maximum and minimum values for each variable are reduced to a scale between 0 and 1, with each country at some point on the scale.'

Nonetheless, there are upper limits to the effective size of government, just as there is a limit to the amount taxes can be raised without hobbling capital formation, investment, and expansion. Beyond some maximum, a rise in public expenditures is no longer accompanied by an increase in the quantity or an improvement in the quality of services provided by government. This 'maximum' is believed to hover around 40 percent of GDP. Thus, the governments defined earlier as 'big' (with public spending exceeding half of GDP) are probably too big, while the 'small governments' (with public spending below one-third of GDP) may be too small. If a drive toward further state expansion is too aggressive, government spending may pass the threshold beyond which additional increments become inefficient and no longer contribute to welfare. In countries where this has occurred, the challenge is turned around: first, how to contain state expansion and, second, how to cut non-productive public expenditure without causing erosion in the standard of living or in future development.

This is certainly not the case in postsocialist economies, where, after the initial sharp reduction in the size of government at the onset of transition, enormous efforts were undertaken to continue the process. Even the notion 'government consumption' is now being exploited to suggest that the state bureaucracy, not society, gains from government spending. If this stubborn push to downsize had permitted the sprouting up of a private sector able to use more efficiently the resources being released by the withdrawal of the state, then it might have been appropriate. However, allocative efficiency was not necessarily improving, and the more limited redistribution of GDP and the restrained fiscalism, instead of producing a positive effect, tended to aggravate the contraction and make it last longer than would probably have otherwise been the case. Moreover, the supply of social services began to dwindle, and the divestment in human capital was weakening the long-run potential for growth.

Unfortunately, policymakers were being misled by the half-baked piece of advice according to which the sooner government becomes small, the sooner the market economy can begin to rise and expand. Instead of focusing attention on the ends of policy, they burned a lot of energy attempting to adjust one important policy instrument. Thus, Jeffrey Sachs (1993) expressed the conviction that '. . . markets spring up as soon as central planning bureaucrats vacate the field.' So, bureaucrats vacated the field and moved to business, to the shadow economy, to policymaking, to cushy consultancy jobs, to organized crime, to countries with better economies, but the markets did not 'spring up'. What instead did happen was the Great Transitional Depression.

Healthy markets can expand quickly within institutionally mature systems, which have abandoned central regulations and which are guided by liberalized government industrial and trade policies. This could occur in a nation like Japan, for instance (though, no doubt, Japan possesses a big

bureaucratic burden and a poor regulatory environment), but it has never happened either in developing countries, as for instance Nigeria, or in transition economies, as for instance Uzbekistan, with weak institutions. In transition economies, the problem is to furnish the new state with the ability to police the economy and develop market institutions, not instantly to liquidate central planning bureaucrats, no matter who the terminator may be.

Chapter Eight

External Shocks and the Catching-up Process

The strongest argument, both economic and political, behind the rationale to push towards postsocialist transition to a market system is a widespread conviction that such a system must bring better allocative efficiency and hence higher competitiveness. In due time it must bring higher output and eventually a better standard of living for the people. Yet to accomplish such a result, not only the pre-transition level of output must be recovered—and even reaching this target in some countries will take another decade or two of hard work—but these economies must be put on the path of quick growth.[1] Furthermore, it must be sustained for a long period of time. Only then there will be a chance for catching-up in transition economies. Catching-up means a gradual, long-lasting process of diminishing the development gap between the richer industrial countries and the transition economies that are lagging behind them, now even more than ten years ago.

While looking into the future, there is always a temptation to presume that it will be fine. Such optimism may seem reasonable from the policymakers' perspective, especially since they always assume that they well know what ought to be done and that unfavorable external shocks, making their ambitious plans impossible, will not happen. Unfortunately, quite often neither assumption holds. Consequently, the future seldom looks as bright as envisaged only a couple of years earlier. Despite such experiences, the optimistic expectations tend to be repeated time and again. And the postsocialist transition economies and their leaders are not exempt from this optimism. It might be added that international organizations are following this pattern of behavior as well, or at least they have done so for several years (World Bank 1997c).

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1. To recover the previous level of output for a country were it shrunk by, say, 50 percent, one needs a decade with an annual rate of growth of 7.2 percent. In the case of output collapse by two-thirds, the full recovery needs two decades of annual growth of 5.7 percent. Under other circumstances it would be recognized as a remarkable pace of growth, yet in such case, for instance in countries like Georgia and Moldova, it would bring, from the production level viewpoint, a return only in 2020 for a situation dating back to 1990. And that is the time span of whole generation.

There would be nothing wrong with optimistic expectations, if only they were based on vast knowledge and true commitment to sound policies on the one hand, and if they were drawing the right conclusions from historical experience, on the other. Otherwise, too much optimism becomes too much ignorance, which always prevents fast growth and its sustainability. Therefore, the considerations about catching-up in transition economies should draw from both their own recent experiences and the characteristic of the growth process occurring elsewhere in the global economy.

As for these experiences, it must be clearly understood why a few countries—actually very few of them—in 1999–2000 produced more that they did in 1989–90, and many others are still not able to do so. There is a question to what extent the rate of growth in the future will differ between various emerging markets in the EE and FSU region? Can it differ as significantly as it did over the last decade?[2] This is hardly imaginable, because there were some unique reasons for such diversifity and it is very unlikely, if at all possible, that they will reappear in the future. Therefore, what kind of reasons were they?

First, there had been local military conflicts. Obviously, the countries affected by these misfortunes have lost a remarkable part of their production, which would not have happened otherwise.[3] Especially Armenia, Azerbaijan, Georgia, Moldova, and Tajikistan in the FSU region, and several Balkan countries in the EE region, have been harmed by heavy losses owing to military operations. In some places the situation is still unstable and, hence, unpredictable. As for the future, all predictions for the future have been presuming that there would not be such type of conflicts. Unfortunately, this has not been the case.

Nevertheless, if the transition process during next decades evolves peacefully—and all necessary attempts to secure such a course must be undertaken—it is reasonable to expect certain additional growth. It might be indirectly deduced from the 1990s data, when the output started to grow rapidly soon after the military conflicts ended. Yet if local or regional conflicts continue, the sluggish economic performance as well as stagnation and depression may last for several more years.

Second, there were other types of external shocks that made the transition exercise still more difficult. Especially for the FSU republics the initial shock following the collapse of the former Soviet Union was remarkable. For this reason alone the transitional recession was much deeper in the FSU

2. In the extreme cases, that is, in Poland and Moldova, the average annual rate of GDP growth in 1990–99 varied from plus 1.95 to minus 10.5 percent. Hence, at the end of the decade, these countries GDP were, respectively, 121.6 and 30.5 percent of the pre-transition level (see Table 3 and Figure 1).

3. It had indeed been a disaster to lose during the short period of just one year as much as 21.1 percent of GDP in Croatia in 1991, or 52.6 percent in Armenia in 1992, or 18.9 percent in Tajikistan in 1994, or 37.3 percent in Yugoslavia in 1999. This kind of single year damage needs more than a few years to recover the prior output.

economies than in the EE countries. The break of the former Yugoslavia was also a great shock for all five republics composing that country. Still meaningful, though of a smaller dimension, was the dissolution of Comecon, the late trade bloc of socialist countries. But all these shocks are already in the remote past and cannot be repeated.

However, as the recent trend following the 1998–2000 Russian financial crisis shows, the transition economies, especially the FSU republics, are very vulnerable for crises occurring in other countries, especially those with which they have strong trade links. Russia, of course, is here the most important country. The more these countries are exposed for trading with a large partner, the more vulnerable they are for the fallout from a crisis that may strike such a partner. Thus in the future the risk of external shocks will depend on the pattern of their trade and financial links.

Considering that the processes of diversification of the main trade partners and the directions from which the capital is flowing continue, there is a likelihood that this vulnerability will decline. Yet at all times there will be a risk of external shocks that can diminish the prospect of that growth. The answer for such a challenge is to maintain strong fundamentals and sound institutions, and to react through wise policy response. Thus, a shield against negative external shocks can and should be created.[4]

Third, certain events, both in the global economy and its postsocialist region, have good and/or bad effects, depending on who is the newsmaker and who is the newstaker. There are several economies, mainly among the FSU emerging markets, which rely to large extent on specific commodity prices. Natural gas and oil for Turkmenistan, oil for Azerbaijan, and cotton and gold for Uzbekistan are of great significance for these countries' income. So is oil for Russia. Without taking a closer look at the fluctuation of these prices, it is not possible to explain such shifts of rate of growth as from minus 26.1 to about plus 17 percent between 1998 and 2000 in Turkmenistan, or from minus 11.8 to plus 5.8 percent between 1995 and 1997 in Azerbaijan.[5]

When, a couple years ago, the prices of oil and gas were plummeting to the lowest level in twenty-five years, it was a negative external shock for the countries whose revenues depend to a great degree on export of these products. And, on the contrary, it was a positive shock for the importers,

4. In Poland, in 1994–97—during the implementation of structural reforms and development program "Strategy for Poland"—there was a special task force, led by the deputy premier and minister of finance, which was working on an early warning system and, if necessary, drafting proposals for policy response that would counteract a threat of negative external shocks, especially vis-à-vis risks stemming from the ongoing liberalization of financial markets.

5. Of course, there were some other specific causes for such huge shifts. In the instance of Turkmenistan, the lack of financial liquidity of certain trade partners contributed to drastic decline of oil and gas sold. In Azerbaijan local ethnic conflicts contributed also to deep contraction.

including a majority of transition economies. Through favorable influence on their terms of trade, it helped to accelerate the rate of growth. That was the case in several EE countries in 1995–97. Unfortunately for the latter group (and, of course, fortunately for the former) the trend turned around in 1999. In the future it will change several times both ways, and once again it is impossible to predict when and in what direction.[6] The remedy for the producers of these primary goods is to diversify their output and thus diminish the ratio of dependency on the revenue collected through export of such traditional commodities. The remedy for the importers is to advance their economies towards a less energy-consuming technology, which indeed is taking place, however not fast enough.

Fourth, in the postsocialist countries not only is a market economy emerging, but democracy is rising as well. Democracy is a value in itself, yet at the same time it is interlinked in a complex manner with the process of economic growth. There is not a clear relation neither between market and democracy (Alesina 1997), nor between marketization,that is, the process of transition to a market system, and democratization, that is, the process of transition to democracy (Kolodko 2000a). There are examples of economies growing fast and becoming durable without much democracy (for example, Chile in the 1980s, or China in the 1980s and 90s), and there are examples of lasting depression under authoritarian regimes (for example, Zaire in the 1980s and 90s). And there are plenty of cases of fast growth under democracy, but there are opposite examples too, when growth is sluggish under democracy.

In transition economies it is also a complex issue. So far, in a majority of cases the process of democratization has advanced even faster and further than that of marketization. This is so because the founding of democracy is an easier exercise that the building of a full-fledged market structure. However, even if the bumpy process of democratization in certain countries over certain years did not ease the efforts aimed at economic growth, it does so

6. In early 1999, when the price of a barrel of Brent oil was slightly over 10 dollars, that is at the lowest level in real terms since the 1974 oil crisis, *The Economist* was predicting this price to fall further to as low as five dollars. Yet things intervened. In a matter of one year it exceeded 25 dollars. Actually, without such a dramatic turnaround of the oil prices, Russia could not have achieved GDP growth of 1.5 percent in 1999.

7. *The Economist* has proposed an interesting illustration of this. Although it is definitely too early to look for a correlation between the scope of democracy and the level of development in the FSU, a sort of confrontation of the evaluation of 'prosperity' and 'democracy', somehow by rule of thumb, has been done. As a result, in the less prosperous countries—and in this evaluation they are Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan—democracy in the latter three is ranked at the lowest possible level. However, the question remains: if there is only a beginning of democracy, is there then also no prosperity—or is it the other way around? Certainly, it is much easier to enjoy democracy with more prosperity, although on the *The Economist* scale in Moldova there is, despite economic misery, a maximum of democracy within the CIS (*Economist* 2000). That can be good hint for future growth.

in the longer run.[7] As for the past, the political turbulence accompanying transition was causing additional difficulties for the implementation of a proper growth-oriented policy. Structural reforms and institution-building, while aiming at the improvement of resources' allocation and the overhauling of the fiscal system, are still more difficult during democratization. Yet without the latter, these changes could be not implemented at all.

In the long run the democracy helps and assists the process of growth, since it may correct the policy excesses. Of course, democracy works better if the market performs well—and the other way around. From such angle it should be foreseen that further progress with democratization, if only supported by growing economy, would pay back in this sense that it will further enhance the growing economy. In the postsocialist countries this positive feedback ought to be one of the main driving forces sustaining fast growth in the very long run.

Fifth, in the recent past severe economic crises and thus output collapse was also due to the lack of responsible macroeconomic policies. The best (that is the worst) examples here are the cases of the failure of fraudulent financial pyramids in Albania in 1997 and the Russian financial crisis of 1998. Yet there were many wrong policies and ill-advised decisions in the course of the 1990s in other transition economies too. It was basically due to weak institutions and underperforming democracy. The more such policies' wrongdoing, the excesses and the mistakes could happen if there is not sufficient professional knowledge how to tackle the issues, and the general political accountability is in short supply.

Nonetheless in the future, due to the increasing maturity of both market and democracy institutions, it is less likely. As a consequence, it is reasonable to expect a wise policy, if not always—then at least more often than during the first decade of transition. Thus the process of learning by doing and further institutional advancement should contribute to relatively higher rate of growth in the future.

Sixth, there were in the past, so for similar reasons there certainly will be in the future ups and downs in economic fluctuations. There will be some external shocks and there will be some policy failures as well. Hence, there will be some periods of acceleration and then a slowing down of economic growth, and then again acceleration and again slowing down, etc. But despite these ups and downs, there will be continuing growth in all of the transition economies. Actually, it will be as it was under centrally planned institutional arrangements, but of a different character.

There are also good arguments in favor of fast growth that are not derived from the lessons of the past and the evolution of the postsocialist system so far, but from other processes taking place concurrently in the global economy and within Europe. Some of these processes are auspicious for the prospects of fast and sustained growth (Fischer, Sahay, Vegh 1997).

On this basis, it is rational to expect that the process of catching-up with more developed countries will indeed take place.

The first argument is that the course of catching-up with ongoing technological progress is gaining momentum. The transfer of new technologies from more advanced economies is significantly contributing to a growing competitiveness of all emerging markets, including the postsocialist ones. If only macroeconomic fundamentals are sound and financial stabilization is accomplished, and if only political institutions perform well, than technology transfer will bring a major acceleration of rate of growth. In this precise area the catching-up process is going to be most visible and most fruitful (Cohen 1998). It makes sense to presume that, *ceteris paribus,* at least an additional percentage point of rate of growth can be obtained in the long term due to this factor. Technology transfer is causing faster increase of the skills of labor than it is shifting up the costs of labor compensation. Because of this, the production placed by more developed countries in less developed countries will increase more than average.

Actually, this mechanism of catching-up has been set in motion already; it is difficult, however, to spot it within the complexity of changes influencing the contraction–recovery–growth sequence in transition economies. In another words, without the current phase of global technological revolution and transfer of know-how, the transition recession could be even deeper and last longer in some countries, and in some other countries the recovery would be weaker and growth slower.

Consequently, the positive spillover effect, through spreading out new technologies and know-how, upgrades the qualifications of skilled workers. But there is also a concurrent harmful process of brain drain of skilled labor from transition countries. That, of course, diminishes their ability to compete and expand, and must be counteracted by better compensation for and larger investment in human development. Sound inflow of foreign direct investment (FDI), together with new technologies and managerial know-how, helps to counteract the flight of human capital. In countries leading in transition, and thus also absorbing a bulk of internal FDI, like Hungary or Poland, there is already net inflow of skilled labor. That means that more qualified people are coming into these countries than leaving them. This is good for future growth.

The second argument is related to the process of integration into the global economy. Transition is not only an indispensable part of globalization, but postsocialist economies have a chance to be one of the major beneficiaries of this multi-track process. However, the picture is going to be mixed here. In this case (much more than in any other) the geopolitical position does matter. In the best situation are the EE countries negotiating their access to the European Union. First the Czech Republic, Estonia, Hungary, Poland, and Slovenia, and later Bulgaria, Latvia, Lithuania, Slovakia, and Romania, followed soon by Croatia, will get a strong boost for their growth ability because of this integration.

There are several reasons justifying such a hope. These countries upgrade their institutional arrangements much more quickly than otherwise along the line of the rules observed in the EU. It facilitates the growth ability in the long run. They may also count for a relatively larger inflow of the FDI than other economies. Indeed, expectations for their future membership in the EU have already attracted considerable internal FDI[8] (Table 6). Flow of needed capital will continue, and for that reason this group of countries is going to grow faster than other economies in transition and, most likely, faster than other regions of the world economy. Integration with the EU could accelerate the long-term rate of growth by at least another one percentage point. The net transfer of resources from Western to Eastern Europe will work here as additional catalyst, too.

The third argument is linked to the progress of knowledge of economic and financial matters. Although not appreciated in the same way as technological revolution, it contributes to catching-up also. The macro and microeconomic management is a much more complex challenge now than it used to be (Kozminski 1993). At the same time, our knowledge of how to tackle the issues has advanced outstandingly. The experience suggests that there is certain lag vis-à-vis adopting this knowledge. This is so for both cultural and political reasons. Nonetheless, with respect to these aspects of integration, further progress must be expected. It is already very well on the way, and it seems rational to expect a further acceleration of such learning-by-doing on the international scale. Although impossible to measure, this factor will certainly enhance the rate of growth in transition economies.

And the fourth argument is that lasting transition, particularly the advancement of institution-building, contributes to removing systemic bottlenecks and structural distortions inherited from the past, as well as those created at the early stages of transition. Therefore it enhances labor productivity and overall economic efficiency. Now there is ground to assume that these countries, on average, will grow faster than the global economy and, especially faster than the developed industrial countries. If this is going to be the case, in due time they might catch up with the latter group.

Fulfillment of the catching-up theory—if it proves to be correct—needs support. Various political, cultural, and institutional factors must come into existence, and specific conditions must be met to set the mechanism of catching-up fully in motion. Now, after the first decade of transition, in several countries, though not yet in all of them, these factors and conditions seem to be at least to a certain extent established.

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8. Out of about 104 billion dollars of internal FDI over the period 1989–99, about 55 percent was located in the group of five EE countries advanced in both transition and their accession negotiations with the EU, i.e., the Czech Republic, Estonia, Hungary, Poland, and Slovenia. The largest of them, Poland, has absorbed about 20 percent of this amount. As for total FDI placed in the EE region, these five countries received about 77 percent of foreign direct capital, while Poland alone received almost 30 percent. It is important to emphasize that the capital flow is actually a net inflow, because external FDI virtually does not exist in these countries. That is, of course, if the capital flight from Russia is disregarded. If it is not, then the net flow of capital to the whole EE and FSU region over the first decade of transition is negative. This implies that more capital has left the region than was invested there—with harmful implications for recovery and growth.

Table 6: Foreign Direct Investment, 1991–99 (in dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	Cumulative FDI Inflow 1991–99	FDI per capita 1989–98
Albania	8	32	45	65	89	97	42	45	43	466	132
Bulgaria	56	42	40	105	82	100	497	401	700	2,023	159
Croatia	na	13	77	95	83	529	346	854	750	2,747	444
Czech Republic	511	983	552	749	2,526	1,388	1,275	2,485	3,500	13,969	967
Estonia	na	58	156	212	199	111	130	575	350	1,791	953
FYR Macedonia	na	na	na	24	13	12	18	175	30	272	121
Hungary	1,459	1,471	2,339	1,146	4,453	1,987	1,653	1,453	1,550	17,511	1,627
Latvia	na	43	51	155	244	376	515	220	150	1,604	642
Lithuania	na	na	30	31	72	152	328	921	400	1,934	415
Poland	117	284	580	542	1,134	2,768	3,041	6,600	6,500	21,566	389
Romania	37	73	97	341	417	263	1,224	2,040	1,345	5,837	200
Slovakia	82	100	168	250	202	251	177	508	500	1,738	326
Slovenia	41	113	111	131	170	178	295	154	210	1,403	596
Eastern Europe	2,311	3,212	4,246	3,846	9,684	8,212	9,541	16,431	16,028	72,861	184
Armenia	na	na	na	3	19	22	52	232	150	478	89
Azerbaijan	na	na	20	22	282	661	1,093	1,024	780	3,882	408
Belarus	50	7	18	11	15	73	198	141	188	701	45
Georgia	na	na	na	8	6	54	236	221	96	621	98
Kazakhstan	na	na	473	635	964	1,137	1,320	1,132	800	6,461	372
Kyrgyzstan	na	na	10	45	96	46	83	52	64	396	72
Moldova	na	17	14	18	73	56	64	88	170	500	76
Russia	na	700	400	539	1,710	1,700	3,752	1,200	3,500	13,501	61
Tajikistan	na	8	9	12	20	25	30	34	29	167	22
Turkmenistan	na	11	79	103	233	129	108	110	100	873	157
Ukraine	na	200	200	100	300	526	600	700	600	2,626	52
Uzbekistan	na	9	48	73	-24	90	167	170	226	759	23
CIS	50	952	1,271	1,569	3,694	4,519	7,703	5,104	6,703	30,965	34
Total	2,361	4,164	5,517	5,415	13,378	12,731	17,244	21,535	22,731	103,826	153

Source: EBRD 1997 and 1999.

na—data not available

Chapter Nine

Passive Scenarios and Active Policies for the Twenty-First Century

Against such a background it seems possible to outline some passive scenarios of catching-up in transition economies as well as to provide some policy recommendations for the actions that ought to help realize more positive results among those scenarios.

In a certain sense the transition ought to be seen as a specific historical endeavor shifting part of global economy from one model of growth and development to another. Although their expansion was following the pattern of cycles typical of a centrally planned system, already in the past all these countries were the growing economies. Hence, there was also catching-up with the more developed regions—at least at the earlier stages of a centrally planned episode, before momentum was lost.

From now on—assuming that the Great Transitional Depression is coming to an end in all countries, including those which did not return to the path of growth prior to 2000—there will be growth following the pattern of business cycles typical of a market system. Therefore, under further consideration there is an implicit assumption that long-term growth will evolve around the trend derived from business cycle fluctuations, yet of unknown characteristics.

From such an angle, the postsocialist economies in transition to a market order are going through the long process of changing the substance of their cyclical growth. They do not move from a system where there was no growth to a new system, where the growth will resume and is supposed to be of a 'better character.' The latter must still happen.

For the time being, there are various forecasts for upcoming years. Actually, in the medium term, nobody foresees for any of the transition economies a further decline of output. There are only a couple of cases where a decline in output is expected, and that is only for a single year.[1] Of course,

1. For instance, PlanEcon—a leading think tank following the developments in the region for many years—in their prognosis until 2003 for the FSU and 2004 for the EE predicts negative growth in only two cases: for Belarus in 2000, minus 8.1 percent, and for Uzbekistan in 2001, minus 1.0 percent (PlanEcon 1999a).

this outlook presumes that developments go peacefully and that there will not be any severe, unpredictable external shocks. Both misfortunes cannot be ruled out *a priori,* because the things do happen. However, such assumptions seem to be rational at this point. Therefore, in 2003 or 2004, the GDP index, comparing national income in those years with the level of GDP in 1989 and 1999, will look less depressing than it does now, although still more than one would like to see. In 2004, the output will surpass the GDP level of 1989 in only seven (maybe in eight, if Estonia makes it) of twenty-seven countries. At the other end of the list, in another eight countries it will still remain below two-thirds of that standard. And that will be after altogether fifteen years of transition (Table 7).

Table 7. Real GDP Index. Forecast for 2003/4 (1989=100 and 1999=100)

	Index 1999	Rate of Growth					Index 2003(4)*	
	1989=100	2000	2001	2002	2003	2004	1999=100	1989=100
Poland	121.6	4.8	5.1	5.5	5.8	4.9	129.0	156.8
Slovakia	101.5	3.8	4.6	6.4	6.0	6.9	130.9	132.9
Slovenia	107.6	4.0	3.9	4.2	4.1	4.8	122.8	132.2
Albania	92.5	7.0	6.7	8.3	6.9	6.5	140.8	130.2
Hungary	99.2	5.3	5.2	5.4	5.1	5.5	129.5	128.4
Czech Republic	94.7	2.6	3.6	4.8	4.7	4.4	121.8	115.3
Uzbekistan	92.3	3.8	-1.0	2.2	3.8		109.0	100.6
Croatia	77.2	2.6	3.5	4.4	4.8	4.7	121.6	93.9
Romania	73	5.3	5.4	5.3	5.0	4.6	128.4	93.7
Estonia	75.7	5.5	5.5	5.1	4.5		122.2	92.5
FYR Macedonia	72.0	4.8	5.5	5.0	4.5	3.6	125.7	90.5
Bulgaria	66.8	4.1	5.0	5.2	4.7	4.4	125.7	84.0
Lithuania	65.4	5.3	5.3	5.7	5.2		123.3	80.6
Belarus	78.2	-8.1	1.7	3.1	5.7		101.9	79.6
Latvia	60.1	4.9	4.8	5.5	5.3		122.1	73.4
Kazakhstan	60.2	3.3	4.5	5.9	6.1		121.3	73.0
Kyrgyzstan	60.4	4.5	4.1	4.2	4.4		118.3	71.5
Azerbaijan	45.2	7.3	9.1	9.7	9.0		140.0	63.3
Turkmenistan	51.2	5.3	5.1	5.0	6.1		123.3	63.1
Russia	56.1	2.2	2.7	2.0	3.4		110.7	62.1
Armenia	42.5	6.2	6.9	7.1	7.2		130.3	55.4
Tajikistan	44.1	5.0	5.1	5.0	5.9		122.7	54.1
Georgia	33.8	8.0	7.8	7.8	7.5		134.9	45.6
Ukraine	35.7	0.2	3.3	3.9	4.6		112.5	40.2
Moldova	30.5	3.7	4.7	5.6	6.1		121.6	37.1
Bosnia-Herzegovina	na	*6.1*	*4.6*	*3.8*	*3.1*	*3.7*	*123.2*	na
Yugoslavia	na	*15.4*	*13.2*	*10.9*	*8.1*	*5.9*	*165.8*	na

Source: Index 1999 from Table 3. Forecast for 2000–04 from PlanEcon 1999a and 1999b.

na—data not available.

*2003 for the FSU and 2004 for the EE countries

If these scenarios are going, by and large, to come to pass, then the GDP per capita will increase also.[2] In some countries with a low rate of population growth it will be on the par with total output growth.

An interesting phenomenon in the postsocialist emerging markets is, unlike in the EU countries and other advanced market economies, that there is still relatively large gap between the GDP counted at the current, i.e., market exchange rate, and its evaluation on the basis of purchasing power parity (PPP). The trend is that this gap will diminish, as the progress of opening up and integrating transition countries in the world economy continues. In another words, there is going to be a long-lasting process of real appreciation of the currencies of transition economies.[3] Such process is already well under way (Lavigne 1999, Kolodko 2000a). If from time to time the currencies of transition economies do depreciate—and indeed sometimes the devaluation is rather a spectacular event—it is not contrary to the longer tendency.

Owing to the instability of the market exchange rate, the change of the relative value of national currency may even suggest a decline of GDP measured in dollars, or euro, whereas it is now growing.[4] For that reason, it is worthwhile taking a closer look at the evaluation of GDP per capita on a purchasing power parity basis. This indicator ought to be regarded as a point of departure for the catching-up process at the onset of the twenty-first century (Table 8).

These data, if only they are evaluated properly, better reflect the actual level of socioeconomic development and standard of living. Hence, this is also the point where these economies and societies are at the time, and not the GDP per capita measured at current exchange rate. If the latter were taken into account, then Russia, for instance, with GDP per capita according to a market exchange rate at around 1,500 dollars, would stand in 2000 at only thirteen percent of the Slovenian standard. With all the drawbacks, she is not that much far behind even the average EU standard. This gap will decrease along the line of the real appreciation of the ruble that will take place in the future, following the progress vis-à-vis financial stabilization and structural reforms. Additionally, that gap will diminish also

2. To be sure, none of the similar scenarios has been fulfilled so far. Thus, considering the experience, it would be indeed unwise to bet that it will be different this time. However, the deviations of these forecasts from the actual developments at this time should be modest.

3. The issue of depreciation, or devaluation, will disappear from the policy agenda when certain countries join the EU and then abandon their national currencies, converting them into the euro. It will be the easiest in countries currently under currency board regime, e.g., Estonia. In such a case it will be done simply by converting from the D-mark (the denomination used under the currency board arrangements as an anchor) to the euro. In the long run, all new EU members from Eastern Europe will join the euro zone as well.

4. It occurred in Poland, for instance, in 1999, when GDP estimated in current dollars dropped by 2.1 percent, whereas in real terms it increased by 3.8 percent.

Table 8. GDP per capita in 1999 and 2003(4), PPP basis*

	1999	2003(4)	Growth (in PPP$)	Growth (in %)
Slovenia	14,267	17,344	3,077	21.6
Estonia	9,096	16,048	6,952	76.4
Czech Republic	9,472	11,442	1,970	20.8
Slovakia	8,395	10,954	2,559	30.5
Hungary	8,063	10,648	2,585	32.1
Croatia	8,284	9,528	1,244	15.0
Poland	7,232	9,255	2,023	28.0
Latvia	6,341	7,877	1,536	24.2
Belarus	5,722	5,737	15	0.3
Russia	4,539	5,087	548	12.1
Bulgaria	3,758	4,796	1,038	27.6
Lithuania	3,680	4,520	840	22.8
Romania	2,962	3,837	875	29.5
Armenia	2,842	3,662	820	28.9
FYR Macedonia	2,897	3,423	526	18.2
Turkmenistan	2,891	3,376	485	16.8
Kazakhstan	2,482	3,028	546	22.0
Yugoslavia	1,828	3,027	1,199	65.6
Uzbekistan	2,612	2,721	109	4.2
Azerbaijan	1,970	2,689	719	36.5
Ukraine	2,348	2,641	293	12.5
Georgia	1,950	2,570	620	31.8
Kyrgyzstan	2,211	2,472	261	11.8
Moldova	1,745	2,104	359	20.6
Albania	1,474	2,025	551	37.4
Tajikistan	748	848	100	13.4

Source: PlanEcon 1999a and 1999b.

*2003 for the FSU and 2004 for the EE countries.

because of a rate of growth in Russia that will most likely be faster than in the most advanced postsocialist countries—if not yet at the onset of the new century, than a little later.

Therefore, we face the question of where all these countries can be in a generation or two. From the perspective of their long-term growth ability, and thus the ability to catch up with advanced industrial countries (or their inability to do so, because none of them *a priori* is bound to succeed), there will be at least four distinct groups of postsocialist economies.

The first group, which may be called 'the gainers', will consist of the economies able to sustain over the very long term the rate of GDP growth at least two times higher than the relevant rate in advanced market economies. As a benchmark in this respect, the recent rate of growth of the EU can be used. Despite the fact that here, too, the future rate of growth is hardly a sure figure, it seems reasonable to assume that it will, by and large,

continue around the level accomplished in 1997–2000.[5] Accordingly, it would be about 2.5 percent (IMF 1999).[6] This implies that, for the gainers, the average annual rate of growth will be at least five percent over the coming decades. In reality, if nothing extraordinary occurs, it may oscillate between four and six percent.

The second group—let us call them 'the even-runners'—will be able to maintain the pace of growth along the lines of the EU, or at most to overcome it only slightly. Thus it will oscillate around three percent on average, jumping between two and four percent. As a result, these countries will not be catching up with most advanced part of the European economy, or if doing so, it will happen at a very slow pace. In relative terms the distance between the two groups will change only very modestly. However, given the different bases, the absolute distance will rise still further. Also the development gap between this group of postsocialist economies and the gainers will increase.

The third group—let us call them 'the laggards'—due to their lack of ability to resolve the transition to their advantage, will grow even less over the long term than the EU economies (and hence the even-runners). Their long-term rate of growth will not exceed two percent, or even may stay below this low level. Thus their relative income, compared with those of other groups of transition economies, will lag behind in the future even more than it did at the turn of the millennium. There are many arguments that all postsocialist economies will be growing economies, yet it would be unwise to assume that, owing to the coincidence of unfavorable circumstances and policies, the worst among them will not be driven from time to time into another recession. Hence, their long-term growth may be very meager.

And there is the fourth group, or at least there is a chance that such group will appear. It can be called 'the frontrunners.' These countries, un-

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5. Forthcoming growth in the East will cause acceleration of the EU overall rate of growth. Notwithstanding that the new members from Eastern Europe will contribute only a minor part of total European Union GDP, its rate of growth over long term will rise by a fraction of a percentage point. Larger common market participation will also play a positive role with this regard. Therefore, the factual rate of growth could be higher than the current 2.5 percent, possibly being closer to three percent.

6. That is, for the Western European economies. As for the USA, the GDP rate of growth over this period of time was significantly higher—at around four percent. It is believed that that this was due mainly to the so-called new economy, which was fueled by the internet revolution and the far-reaching deregulation of financial markets. Actually, there is one more structural component of this boom. That is globalization itself, since the American economy happens to be the greatest beneficiary of it. Hence, it enjoyed extraordinary growth. Yet this pace of growth, unlike in the EU, does not seem to be sustainable. Aside from the structural features, it seems so dependent on another important factor, the bubble in the stock market. For a certain period of time it may facilitate growth strongly, yet eventually it must burst and come to an end.

der a lucky coincidence of favorable circumstances and good policies, will enjoy an average annual rate of growth around three times higher than that of the current EU zone; that makes 7.5 percent annually. Thus, running between six and nine percent annually, they will gradually approach the EU and OECD development standard,[7] whereas at the same time they will be leaving behind all other postsocialist economies.

These are the general reflections vis-à-vis the alternative pace of growth; it does not mean that each country growing faster will enjoy higher output and, consequently, a better standard of living than a country growing at a lower rate. In the long run, that must eventually happen. However, for several years, it can be just to the contrary, because of the very logic of the catching-up mechanism. It means that countries departing from a lower level of output in 2000, for example, Azerbaijan in the FSU region or Albania in the EE region, although they will report faster growth than, for example, Estonia and Slovenia, will for a number of years still have a relatively lower income.

In Azerbaijan, GDP per capita (at PPP basis) was estimated in 1999 at about 1,970 dollars, while in Estonia at 9,096—almost five times as much. Against this background, it is assumed that, whereas in the former GDP will increase on average between 2000 and 2003 by 7.0 percent, in the latter it will grow only by 4.1 percent per year. However, absolute production will remain much larger.

As for Albania and Slovenia, the relevant GDP per capita on PPP basis is 1,474 and, respectively, 14,267 dollars, which is almost ten times as much, while the expected rates of growth are 7.1 and 4.2 percent. Therefore, while sticking to the categorization given above, during the near future, not surprisingly, Albania and Azerbaijan can be found among the frontrunners, whereas Estonia and Slovenia, which are much better developed, can be found among the gainers, and amongst them—only at the very end of the league (Table 9).

These predictions must be seen as passive scenarios, which are based on both an extrapolation of recent trends and certain assumptions vis-à-vis the policy reforms in forthcoming years. As for the forecast, it is significantly less optimistic than it was only a couple years ago. Such a change of mood results, in part, from the negative external shocks that have influenced not only the real economy, but even more the ways of thinking about it and the expectations. Thus it might happen that this time, contrary to the early 1990s, there is an excessive pessimism.

Nevertheless, it is true that the Russian 'crisis within a crisis' and its 1998 financial climax has affected not only several FSU republics, but also the economies of Slovakia and Estonia, which were previously more rap-

7. To OECD belong also the new members, with relatively lower GDP per head, including Mexico. Among them are three transition economies, Hungary, the Czech Republic, and Poland, which have joined the club (in that order) in 1995–96.

Table 9. Average Rate of GDP Growth in 2000–03(4)*

Frontrunners	
Yugoslavia	10.7
Albania	7.1
Azerbaijan	7.0
Georgia	6.2
Gainers	
Slovakia	5.5
Armenia	5.5
Hungary	5.3
Poland	5.2
Romania	5.1
FYR Macedonia	4.7
Bulgaria	4.7
Lithuania	4.3
Turkmenistan	4.3
Bosnia-Herzegovina	4.3
Slovenia	4.2
Tajikistan	4.2
Estonia	4.1
Latvia	4.1
Even-runners	
Czech Republic	4.0
Moldova	4.0
Croatia	4.0
Kazakhstan	4.0
Kyrgyzstan	3.4
Ukraine	2.4
Russia	2.1
Laggards	
Uzbekistan	1.8
Belarus	0.5

Source: Estimated on the basis of the PlanEcon 1999a and 1999b forecast.

*—2003 for the FSU and 2004 for EE economies.

idly growing, owing to their large exposition for trade with Russia. In other rapidly growing countries, such as Poland and Slovenia, deceleration of growth had occurred more as the result of policy mistakes. In Poland in 1998–99 such mistakes had brought down the previous medium-term rate of growth by one to two percentage points (see Figures 2 and 10). As far as the active policies are concerned, they can possibly bring the pace of growth back to nearly 7 percent and sustain it at that level for many years, keeping these economies among the frontrunners. That is possible, and even likely. Consequently, these and other scenarios would soon change in an opposite,

more optimistic direction. The forecasts depend mostly upon the policies, not the other way around.

Therefore, four types of long-term growth can be outlined. They correspond with the four types of postsocialist growing economies described above. Accordingly, there will be four paths of long-term growth, respectively, for gainers, even-runners, laggards, and frontrunners. In line with these assumptions, the postsocialist economies will grow along the paths ranging from less than 2 percent per year to as much as 9 percent per year. So, where can a particular country arrive after a journey along certain paths of growth, if it stays the course of a specific pace of growth for a given number of years during the next fifty years? Figure 4 points to some hypothetical answers (Figure 4).

Within these four hypothetical scenarios there are three sub-scenarios, the core scenario A, the minimum scenario B, and the maximum scenario C. The extreme sub-scenarios, the minimum and maximum, are based upon the calculation that, over the entire half-century period of time, the rate of growth is either at the minimum or at the maximum end of the band, the center of which is given by the core scenario. Where would such scenarios lead those countries? (Table 10)

The first scenario presumes an initial medium-term (five years) period of slow growth, due to unstable fundamentals, weak institutions, inadequate policy response, and negative external shocks. Then the growth accelerates for the next five years, due to continuing institution-building and policy reforms, as well as more favorable external factors, for example, an end to the regional conflicts. Later the acceleration gains momentum due to institutional advancement and better policies, because of the experience and knowledge gained from learning by doing. Hence, the growth rate advances these economies to the group of the gainers. That means it bounces within the range of 4 to 6 percent over a full decade. Afterwards, the pace of growth declines for the long-term of three decades, yet only to the pace of the even-runners, that is, 3 percent on average.

Thus, in the span of one generation it lifts national income almost twofold, and over two generations, that is by 2050, it might increase about five times in real terms. However, considering the range of fluctuations of the rates of growth, in sub-scenarios 1B and 1C, it can be much less or significantly more than in the core scenario 1A (see Figure 4.1).

Such scenarios are likely for the countries that still have weak fundamentals, poor institutions, delayed structural reforms, inconsistent development policies, relatively less favorable geopolitical position, and, in certain cases, might be directly or indirectly affected by local tensions and conflicts, too. For instance, countries like Tajikistan in the FSU, or Romania in the EE region, seem fit to a certain degree in these scenarios. However, the future will bring a lot of mutations that will make the real picture even more colorful. Nevertheless, these countries can accelerate their rate

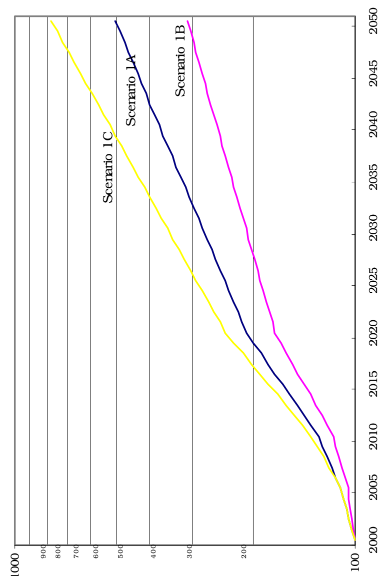

Fig.4.1 Alternative Growth Paths for the Very Long-Term, 2000-2050

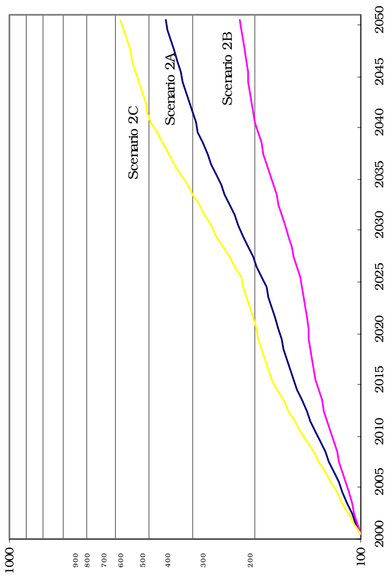

Fig.4.2 Alternative Growth Paths for the Very Long-Term, 2000-2050

Fig.4.3 Alternative Growth Paths for the Very Long-Term, 2000-2050

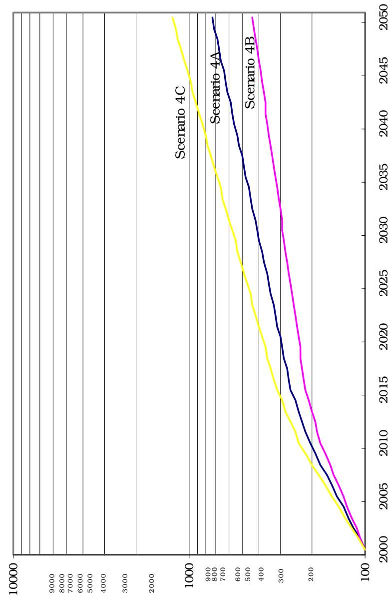

Fig.4.4 Alternative Growth Paths for the Very Long-Term, 2000-2050

Table 10. Catching-up in the Transition Economies in the 21st Century

	1A	1B	1C	2A	2B	2C	3A	3B	3C	4A	4B	4C
Year	Laggards-5 Even-runners-5 Gainers-10 Even-runners-30	Min	Max	Even-runners-15 Laggards-10 Even-runners-15 Laggards-10	Min	Max	Gainers-10 Frontruners-10 Gainers-5 Even-runners-25	Min	Max	Frontrunners-10 Gainers-5 Even-runners-35	Min	Max
2000	100	100	100	100	100	100	100	100	100	100	100	100
2005	110	105	110	116	110	122	128	122	134	144	134	154
2010	128	116	134	134	122	148	163	148	179	206	179	237
2015	163	141	180	156	135	180	234	198	276	263	218	317
2020	208	172	241	172	141	199	336	265	424	305	241	385
2025	242	190	293	192	149	220	428	323	567	354	266	469
2030	280	209	356	222	164	267	497	356	690	410	293	571
2035	325	231	433	258	181	325	576	393	840	475	324	694
2040	377	255	527	296	200	395	668	434	1022	551	357	845
2045	437	282	641	327	210	437	774	479	1243	638	395	1028
2050	506	311	780	361	221	482	897	529	1512	740	436	1250

Source: Author's calculation. See text for assumptions.

of growth later only if they are able, through proper policies, to get rid of various structural and institutional bottlenecks that are still keeping their growth potential in check.

The second scenario is for the countries that will take only limited advantage of the chances the introduction of a market economy is bringing. For this reason they will grow at a rate even lower than they did under the centrally planned system (see Table 1 and 2), yet this growth will surely be accompanied by further increasing inequality (Milanovic 1998, Kolodko 1999c). At the outset, for the first, say, fifteen years, they will grow at about 3 percent annually and then even more slowly, at about only 2 percent. Then, during the period of the second generation, the sequence of the fifteen years as the even-runners and the ten years as the laggards could be repeated.

All these are probable for the countries that at the beginning of the century are still muddling through inconsistent structural reforms and are burdened by the institutional vacuum. Old institutions have been already dismantled, but the new ones are not yet in place. This type of a hybrid system contributes to making the growth more difficult and diverts the opportunity to catch up into an illusion.

If even the geopolitical position helps and the human capital is relatively fine, the weak fundamentals and unstable political situation can discourage domestic capital formation and hinder absorption of the flow of foreign savings, that is the internal FDI. Thus, such a group of countries can be as far behind the average global income in the year 2025 and 2050 as it is in the year 2000, because it will rise only by about 260 percent or so over this long term (see Figure 4.2). What countries can belong to this group, that is, what ought to be left for themselves to decide, since, according to the logic of the way of reasoning presented thus far, none of them is doomed for such a meager growth? Once again, it depends on the policies. In short—the countries do have a choice.

The third scenario reflects a situation when over a span of 10 years or so the average rate of growth sustains about 5 percent, oscillating between 4 and 6. That might be plausible for the gainers with strong institutions and improving fundamentals as well as reasonable policy response and advanced structural reforms. During the succeeding decade the growth might even jump to 7.5 percent and then retreat once more to about 5 percent for the medium term. After a time span of one generation it would slow down to the pace of the even-runners, where it could be maintained for another twenty-five years. That would indeed be an extremely successful path of growth. In such a case the catching-up would be complete, since at the end of the journey along such lines, the income would be on the par with the standard of the developed industrial countries.[8]

8. Of course, the income is the flow. As for the standard of living, which is a function of both, the flow and the stocks of assets accumulated in the past, it would be still firmly below the level enjoyed by the most advanced societies.

So, which countries may have a chance, if they meet all necessary criteria, to accomplish such remarkable growth? With luck, perhaps, it may occur with the regard to the best performers amongst the countries aspiring to join the EU, especially those from the first group of applicants. It is hardly imaginable that all of them will take such a path, yet the best among them at least, *ex ante*, seem to have a chance (see Figure 4.3). If so, looking at things realistically, they should fit close to minimum sub-scenario 3B, because the maximum one, i.e. 3A, is rather on the verge of a postsocialist miracle. Of course, a miracle would help; the problem, however, is that the miracles fail to happen not only in East Asia, but in Eastern Europe, too.

The fourth scenario (see Figure 4.4) is also a very optimistic one. An increase of real income over sevenfold during a half-century period has not happened that often in the course of history. Indeed, it has occurred very seldom (Cohen 1995). Nonetheless, under certain circumstances, this can happen in the case of leading transition economies, on the one hand, and in the case of some of them that are quite underdeveloped, on the other. Thus the economies that can aspire to this first group (as in the previous scenario) are those with stronger fundamentals and matured institutions, say, the members of OECD, which are able simultaneously to manage sound policies and firmly take advantage of their integration with the EU, as well as attract a continuously large inflow of FDI.

For instance, for Hungary or Poland among the EE emerging markets, or for Estonia within the FSU region—if they have learned the proper lessons from their own and the other's mistakes—this scenario is not unimaginable. Also important is their very favorable geopolitical position and their good quality of human capital. Yet the policy is going to be decisive, particularly the policy enhancing entrepreneurship. Open product markets, flexible labor markets, and well-developed capital markets make it easier for entrepreneurs to start new firms. This kind of 'venture privatization' and grass-roots entrepreneurship will have a crucial importance for sustaining high-speed growth (Kolodko 2000b). Therefore, over the first decade of the twenty-first century, these types of economies would grow as the frontrunners, having a growth rate at about 7.5 percent on average. It means that, in this case, the GDP would double over ten years, that is two times sooner than under the first scenario. Later, when catching-up will be somehow advanced, the rate of growth would decline to 5 or so percent and then would fall to the level of the EU. By that time all these countries will already be full-fledged members of the union for several years.

But this scenario vis-à-vis the pace of growth and the sequence of its change can match also the characteristics of another type of economies, which is starting from the lowest level of income amongst postsocialist economies. Despite weak institutions and unstable fundamentals, despite lagging behind with structural reforms, and despite often not following the most reasonable policy response, they can take off towards this kind of

catching-up, too. That is because of the coincidence of two specific factors, which, at the top of many other features facilitating fast growth, do matter for catching-up. These features are the nascent fruits of transition as such, that is, liberalization and privatization contributing to increasing once again capital accumulation[9] and to the improvement of efficiency. Other factors are the valuable natural resources and very low starting point.

For instance, Azerbaijan fits this category well, as can Tajikistan. Their level of development gives them a better chance to grow fast, since they are starting from a GDP per capita of only 1,970, and about 750 dollars, at PPP basis, respectively (see Table 8). If the other conditions are met—particularly if there is a conclusive end of regional conflicts, and if the policy response gives a chance that the situation is taken toward the advantage of growth—then they can indeed begin their fast growth.

Later, these two very different groups of postsocialist economies, after upgrading their development level remarkably over the next fifteen years or so, will expand at the pace of the even-runners during following thirty-five years. But then, possibly, the first, more advanced group will be closer to the lower limit within the band of 2 to 4 percent annual growth, whereas the less developed counties will be closer to the upper limit, that is to 4 percent. Thus, in this scenario—as in the scenarios two and three—the critical catching-up would occur at the beginning and middle years of the whole period, whereas closer towards its end the rate of growth supposed to be basically on the par with developed countries.

Yet it can happen that the entire process of catching-up will be postponed, if the structural reforms and institution-building are performed profoundly. It can also be delayed if the political situation, both on the domestic as well as on the international and regional scene, turn out to be adverse. It may be deferred, too, if globalization goes off course and instead of streamlining the ongoing process of transition—hampers it.

The true future of postsocialist economies will be much more complicated (as well as interesting and challenging at the same time) than that outlined in these hypothetical scenarios. As in the case of the movies, the best scenarios are inspired by the real occurrences—not the other way around. It is extremely unlikely, if possible at all, that any particular country's course will remain unchanged for the very long run—a time span of a generation or two. The countries may switch from one path of growth to another. And they will do so in both directions, that means up and down, depending on the changing domestic and international conditions and contingent on the changing policies. Some of them will be not able to avoid a threat of recession when hit by external shocks or by their own policies'

9. Once again, since the ratio of accumulation (capital formation) over GDP (NMP) under the centrally planned economy usually was quite high and much higher than at the time in the market economies (Bauer 1978, Kolodko 1976 and 1986, Kornai 1986, Lavigne 1999).

excesses. Many of these changes are completely unpredictable at the moment. Many others will be the matter of political decisions that may or may not be taken. That in turn will depend on the institutional aspects of development and the democracy's performance. Of course, the latter is also capricious, especially in the nations with relatively young democratic regimes.

Whereas for some countries the future development game will be about sustaining the path of growth they have been able to take earlier, for some others the struggle will focus on getting to the path of faster progress (Lucas 1999). Or, in certain instances, it might be about making the effort not to lose the momentum and slipping into reversal. Thus, the future of the postsocialist economies depends on their particular path of economic growth and for how long they will be able to remain on that route. If we assume that during the next fifty years each country may take no more than a maximum three of such paths or change the course up and down more than, say, five times, it creates several feasible scenarios of further development. These scenarios are far from uniform. As far as their development levels, and hence the differences between these levels, are concerned, the more time that evolves, the more the former centrally planned economies will grow apart.

In the extreme cases—although it seems almost unlikely—any individual postsocialist economy can expand for the whole period of a half-century as the frontrunner, or it can drag as a laggard for just as long. That probably will not happen, because there are very few arguments that lead us to expect a country running on average at a 7.5 percent rate of growth until 2050, that lead us to be pessimistic enough to think that there will be a country increasing its output by a very low margin, say just one percent per year, if at all.[10]

Rationally, it should be expected that these economies will belong to neither extreme group, but rather to the central one, that is, to the gainers and the even-runners. It implies that time and again they will manage to stay on the course of rate of growth within the range relevant for these two groups, that is between 2 and 6 percent. However, within this still quite wide band one may expect that most often the data on GDP growth for the FSU and EE nascent market economies will fluctuate between 3 and 5 percent.

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10. However, modern history knows a few examples of similar kinds of expansion and misery. In the case of South Korea, the rate of growth matching a frontrunner pace in this categorization, had lasted for a quarter of a century. The case of China is similar thus far. Moreover, fast growth in South Korea may continue under certain circumstances, if necessary structural reforms and institutional changes in the aftermath of recent crises are properly executed. On the other hand, there is the case of Chad, where over last three decades output has shrunk by a half, and fast sustained growth is hardly around the corner. The same can be said about Myanmar. Unfortunately, these are only a few examples, since there are more similar gloomy examples, especially in Africa.

It depends on several factors that can be read from the way of reasoning thus far. Yet before recapitulating it, it is necessary to distinguish between passive scenarios and active strategies. The path along which travel towards the future (hopefully a better one) will lead depends on many variables. Some of them are given, and hence we can only try to foresee them more or less accurately and clearly. However, the critical mass of the growth process is contingent to chosen policies and the political ability to follow the lead. Again, the geopolitical position, inherited culture, quality of human capital and skilled labor, the number of the population, and thus the scope of products and service markets, the stock of natural resources, the beauty of a country, and its tourist attractiveness—all these given factors do matter for the growth prospect. Some of them are set forever, some can be changed only over a long time and only under the conditions of a growing economy. But what matters most is the policy. Without a sound one, even a comparative advantage given by other factors will not serve the purpose of development well.

Countries with a better geopolitical position, having the advantage of closer proximity to vast markets, as Estonia to Scandinavia, the Czech Republic to Germany, Bulgaria to Turkey, or even Kyrgyzstan to China, are finding themselves in a relatively better situation to grow faster. The countries aiming at integration with the European Union find themselves in an even better position. Countries that with true commitment are taking care of gradual institution-building, as for instance Hungary and Poland, will benefit from this strong foundation in the years to come more than other emerging markets in the region. They do already.

The combination of these two factors—a favorable geopolitical position in Eastern Europe and substantial progress vis-à-vis institution-building—is already boosting growth of the candidates for entrance into the EU. Those countries, especially those realtively more developed, as the Czech Republic, Estonia, or Slovakia, will grow faster than other countries in the region. That entire group can be seen as gainers in the next decade. Some of them, under wrong policies or unfavorable external shocks, might be downgraded to the lower league. Yet before they catch up with Western Europe (or at least with its southern part, relatively less advanced), they should not remain there for too long. It means that even if from time to time they will not succeed in sustaining the rate of growth at about 5 percent annually, they can be back on the path soon after.

As for the countries advancing occasionally to the upper league, they will be coming from two different groups. The first will include the true leaders of transition, who are able to combine sound development strategy with comprehensive structural reforms. These are two different, yet strongly interrelated issues. Healthy institutions brought by structural reforms and improving market culture are not substitutes for good policy and wise development strategy. They are just complementary. In transition economies

there is not a straightforward causal relationship between structural reforms and development. At least there is a clear message from the record of the first decade of transition, that this has not been set in motion thus fur. Since this relationship does not work automatically, it must become a candid concern of the government policy.

So far, there have been only three cases of high-speed growth that deserve to be counted as the frontrunners. However, it was this way only for a while. Estonia in 1995–97 and Poland, for one year longer, in 1994–97, were growing at average rate of 6.3 percent. So did Croatia for a while. Slovakia was able to follow the suit during the latter period of time with the growth rate of 6.2 percent per year. These three countries, as well as others working out their way toward the EU, have a chance to repeat such accomplishments in the future. It calls for good coordination of fiscal and monetary management, well-designed industrial and trade policies, and subordination of structural reforms to the pro-growth policy.

The problem is that across the region, both the FSU and EE the governments tend to neglect this latter aspect of long-term growth. This is so because they are often advised (and they tend to follow such advice eagerly) that further reforms alone, particularly full liberalization and privatization, will do the job. Later, when the latter unfortunately is not done, the postponement of these structural reforms is blamed for 'unexpected' underperformance. And if there is no way to accelerate those reforms still further, owing to the political and social constraints, then the external shocks are used as an excuse for the failures vis-à-vis the growth policy. From this angle, the Russian financial crisis of 1998–99 has come to the rescue of many governments in transition countries, as well as their foreign institutional and individual advisors, because it has served the purpose of the scapegoat extremely well.

The second group of economies advancing periodically to the frontrunners is going to surface from the less-developed postsocialist economies, literally catching-up with their more advanced neighbors. If additionally these countries take good advantage of foreign aid, which in some cases, for example, Albania and Bosnia-Herzegovina, is not negligible, they can move forward quickly indeed. It did happen incidentally during the first decade of transition, but it will happen more often over the next decades. Leaving aside Bosnia-Herzegovina with an unusual, soaring rate of growth in 1996–98 (over 40 percent on average)— which was due to the postwar recovery financed entirely from external sources, mainly grants—Albania in 1993–96 had the average rate of growth of 9.2 percent. In Georgia in 1996–97, GDP was increasing by 10.2 percent annually. Similarly, in Azerbaijan, in 1997–98, the average rate of growth was 7.9 percent (see Table 3).

However, all these processes have turned out to be unsustainable in the face of weak fundamentals, poor institutions, inconsistent policies, and negative external shocks. Hopefully, that will change again, this time mov-

ing in the right direction. Already, and with good reason, very high rates of growth are predicted for the early 2000s in the three countries mentioned above. All of them—plus Yugoslavia, which is recovering from the devastation of the 1999 war—can turn into frontrunners for some period of time (see Table 9). Yet if that happens, once again, it will not mean that fast growth will be guaranteed for very long. It is necessary that the active policies coordinating proper structural reforms with development strategy will be carried out.

The small differences vis-à-vis rate of growth become large ones in the long term. When considering the next half-century, a difference of only one point between three and the four percent annual rates of growth makes as much as 272 percentage points on a cumulative basis. That is enough to catch up and close quite a big gap. For instance, if a country like Hungary starts from current GDP (on a market exchange basis) of about 5,500 dollars and would be able to sustain, for the next fifty years, a 4 percent rate of growth per year, it would bring GDP up to as much as 39,000 dollars. That is more than today's national per capita income in the United States.

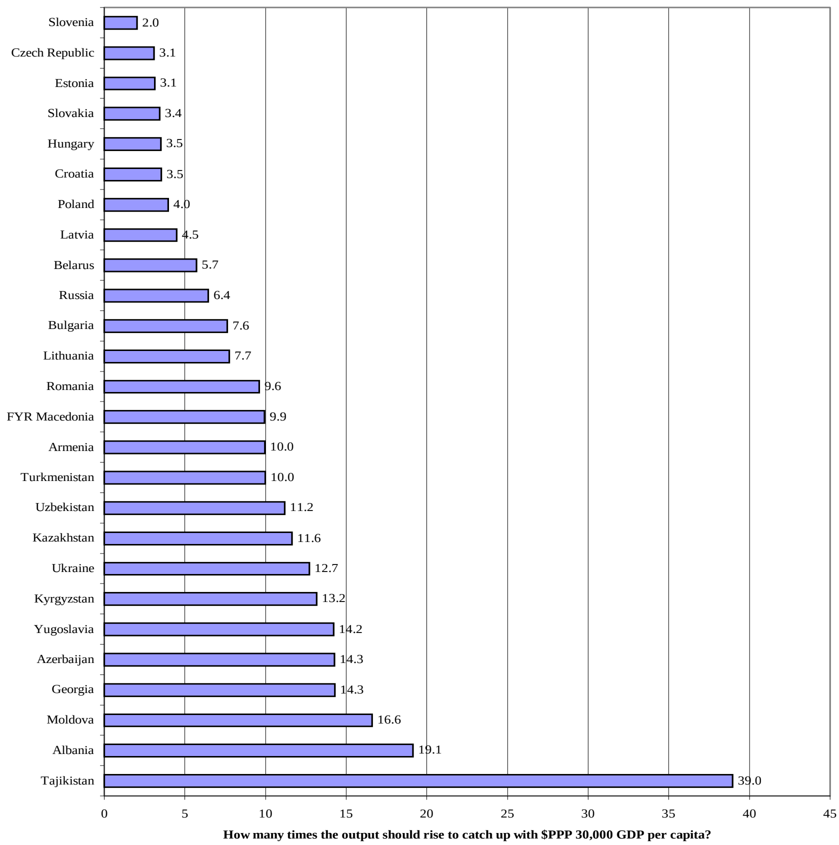
If it grows by only 3 percent over the next five decades, then in 2050 it will make 'only' about 24,000 dollars.[11] This is hardly enough to catch up with the EU average, which is increasing all the time, to the point where it firmly will exceed 50,000 dollars, even if over next fifty years it grows by a mere two percent annually. So, one percentage point does indeed make a difference. And the higher the rates of plausible growth are taken into account, the larger the difference becomes.[12] There are various hypothetical scenarios. Hopefully, some of the optimistic amongst them may become realistic, too, if only the relevant assumptions hold.

What a particular country's GDP per capita will be in the future, depends on its value at the point of departure in 2000 and the pace of growth over the next decades. Assuming that the GDP per capita, on a PPP basis, in the most advanced industrial countries—that is in the EU and USA—is approximately 30,000 dollars, we ask how many times the current level of GDP per capita in transition economies must increase to match the former. The specter of the multiplying factor with this regard is quite vast—from about two times in the case of the most advanced postsocialist economy, that is, in Slovenia, with the GDP per capita at around 14,800 dollars, to about as many as thirty-nine times in the case of the most underdeveloped

11. However, it is more rational, for the purpose of catching-up, to consider the GDP measured in terms of purchasing power parity. Therefore, in the example of Hungary, the respective values would be 57,000 and 35,000 dollars.

12. For instance, if the one-point difference is between the annual rates of growth of 1 and 2 percent, the difference after fifty years accumulates to about 170 percentage points. However, if it is between 6 and 7 percent, than the cumulative difference is as large as 1,100 percentage points.

Figure 5: Catching-up with the Developed Countries



Source: Author's calculation.

country, that is Tajikistan, with the GDP per capita at about 770 dollars. Whereas for only eight countries the ratio is not larger than five to one, in twelve cases it is believed to be no less than ten to one (Figure 5).

Indeed, there are certain methodological concerns about the relevance of the data used for the purpose of this comparison. The evaluation of GDP based on purchasing power parity ought always to be looked at with proper consciousness, and even more, it must be the practice vis-à-vis such proxy for transition economies. It must raise some doubts if the evaluation of GDP per capita (in 1995 PPP dollars) suggests that Estonia is on a par with the Czech Republic, or that Belarus' income is almost twice as much as Ukraine's, or that Macedonia has a GDP per head almost 70 percent larger than Moldova. However, these estimations are based on the same method-

ological ground and are done along the lines of similar assumptions. So if there is—since certainly there is—some error included in those estimations, it still allows us to rely on these data in a quest for answers to the questions that have been asked in the context of recession, recovery, growth, and catching-up in transition economies.

Moreover, catching-up is about much more than just the closing of a gap between level of income in the most advanced nations and in the ones lagging behind in this respect. On the one hand, even if, in certain cases, after a certain period of time the income gap is closed, the standard of living will still be lower, owing to the accumulated wealth. Liquidation of the difference vis-à-vis the latter will take another number of years of relatively faster growth. That will be also catching-up, though first things must happen first.

On the other hand, many postsocialist countries are not that far behind the countries with the highest GDP per capita as simply the data on GDP might suggest. The GDP is just a flow of current production and does not reflect other aspects of development, otherwise important for the standard of living and the quality of life. In several transition economies—and this time it is a positive legacy from the centrally planned episode—there is relatively long life expectancy, on a par with the OECD, the rate of literacy is very high, secondary school enrollment is similar to that in advanced industrial societies, etc. (UNDP 1999).

This does have a significant implication for the future. It shows that the quality of human capital, and hence the growth potential, which is dormant for the time being, are relatively higher. If the growth in terms of quantity supplied can be considered as a linear process, it is not so with socioeconomic development. The nature of the latter is going to change considerably during the era of globalization and vast expansion of information technology. Altering values of society are contributing to this evolution, too.

In the long run the model of development is going to change. Accordingly, the measures of development will evolve as well. They will take much more into account the quality of human capital, standard of natural environment, access to culture and nature, density of urban areas, and other issues that are omitted in the GDP index. Some of the items that thus far are counted in the GDP, and hence are raising the standard of living, in due time can be considered as an obstacle to this end.[13] Therefore, the catching-

13. Actually, the famous mark of economic progress—the car—in the huge cities in emerging markets, including the postsocialist ones, more and more appears as rather an obstacle to the improvement of the quality of life, not a positive contributor to it. The moment to subtract from the composite welfare index the value of time wasted in traffic jams will arrive, as will the moment of including in it the value of space and fresh air. Perhaps it will occur even sooner than the transition economies will be able to catch up with the most developed part of our global village.

up may take a shorter period of time (or sometimes, unfortunately, just to the contrary, it will take longer) than can be seen through the simple prism of catching-up with the quantity of the output flow. Nonetheless, this very output always will be a crucial factor for the nations' standard of living, since this is the true foundation on which one may try to build his or her well-being.

As a consequence of all these circumstances, while regarding the turn of the millennium as the starting point towards catching-up, particular postsocialist countries would catch up with the level of output of the developed world in very different years. Of course, the latter countries are the growing economies, too, so actually this catching-up should be seen as running towards a forward-moving target. Yet here it is assumed that to get only, in due time, to the current level of production of the world leaders would be quite an achievement. Which year it indeed might happen to be—if such a year arrives at all—depends on a path of growth along which the country evolves: is one going to be more like a frontrunner, or rather like just an even-runner? The laggards, of course, do not count (Table 11).

All these paths show how long the distance is to be overcome for the sake of catching-up and closing the development gap, which has risen during the centuries and, unfortunately, deepened even more during just one decade of the last century, when the postsocialist transition had just gained momentum. It might happen that in certain cases not a half-century, but several centuries will be needed to liquidate it completely, if at all, because the catching-up of transition economies does not mean that it is an imperative. It is only an option or a chance, which can be made use of, or can be lost—as it has happened so many times in the course of the mankind's history.

It would be more reasonable for the purpose of catching-up—and that means, too, for upgrading people's living standard—to sustain a stable, yet relatively high rate of growth for a very long period of time, than to attempt its maximization over a certain time, which comes to its limits sooner than expected. In such a case, owing to the risks involved and the likeliness that the economy may get out of balance and consequently slow down, even if for only a couple of years, the final result might be less impressive. In another words, it is a better strategy to be the gainer all the time than to be the frontrunner for a while, but at the price that later one becomes an even-runner only, if not a laggard.

Thus in the medium term, say for the next decade or two, several postsocialist countries should try to find the path of growth that will enable them to advance in the catching-up process only as much as feasible. This will make unquestionable sense of the whole transition and can even make it a final success. Such success is contingent on patience, good policies, and years of hard work.

Table 11. The Year of Catching-up with the Developed Countries

	GDP per capita in 2000 (in 1995 $PPP)	The Year of Catching-up with the GDP per capita of 30,000 $PPP		
		Frontrunner	Gainer	Even-runner
Albania	1,569	2041	2060	2100
Armenia	3,009	2032	2047	2078
Azerbaijan	2,101	2037	2055	2090
Belarus	5,238	2024	2036	2059
Bulgaria	3,930	2028	2042	2069
Croatia	8,484	2017	2026	2042
Czech Republic	9,699	2016	2023	2038
Estonia	9,606	2016	2023	2038
FYR Macedonia	3,017	2032	2047	2077
Georgia	2,099	2037	2055	2090
Hungary	8,525	2017	2026	2042
Kazakhstan	2,576	2034	2050	2083
Kyrgyzstan	2,279	2036	2053	2087
Latvia	6,681	2021	2031	2051
Lithuania	3,872	2028	2042	2069
Moldova	1,805	2039	2058	2095
Poland	7,575	2019	2028	2047
Romania	3,124	2031	2046	2076
Russia	4,654	2026	2038	2063
Slovakia	8,707	2017	2025	2041
Slovenia	14,802	2010	2014	2024
Tajikistan	770	2051	2075	2124
Turkmenistan	3,004	2032	2047	2078
Ukraine	2,357	2035	2052	2086
Uzbekistan	2,681	2034	2048	2082
Yugoslavia	2,108	2037	2055	2090

Source: The 2000 GDP per capita from PlanEcon 1999a and 1999b.

Forecasts—author's own calculation.

Chapter Ten

Policy Conclusions

Having said that much, it is now time to ask one more essential question: are all these analyses and conclusions correct, and especially are the forecasts reasonable, if they happen to have been wrong so many times in the recent postsocialist past? The answer consists of three parts. First, there were many warnings and predictions that accurately were pointing to the risks and to the future unpleasant occurrences, yet they had not been taken sufficiently into account by the policymakers, including international organizations. Second, theoretical assumptions that the transition countries can become fast-growing economies have been correct, nonetheless the conditions for such a take-off were not fulfilled at the time, due, among other things, to policy failures. And third, now is a time to presume rationally that such conditions can be met, so that growth can accelerate as well. However, there are differences and there are also risks.

One difference between then and now is that now we suppose we know much better than earlier what works in postsocialist economies, and why, and what does not work, and why. Although, there has been the false assumption that unleashed market forces will themselves do the development job. They will not. For this reason, the governments' sound development strategies and wise involvement of the international community, including official and non-government organizations, must support the market forces. Hence, the first risk is that such involvement can be insufficient or guided by wrong economic theory.

A second difference between then and now is that at the onset of new century all these transition economies are already growing. So the question is not any more how to stop recession and depression, but how to accelerate the rate of growth and sustain it at the highest possible level for the longest possible period. All the time there is a challenge how to do it within the framework of specific institutional and political environments of nascent postsocialist market and democracy. A negligence of this enduring specificity creates the second risk.

Policies exercised during the first decade of transition have, to a large extent, been derived from the so-called Washington consensus, although

this set of structural reforms was designed for another challenge (Williamson 1990 and 1997). Yet while applied towards postsocialist economies, these policies have greatly influenced the direction of systemic reforms and the course of change (Stiglitz 1998a). However, the transition has also had a significant counter-impact. The policies have not generated the anticipated results, and this has led to a search for alternative measures (Kolodko and Nuti 1997). As the postsocialist markets have emerged, so have fresh issues, problems, and concerns. The reactions to these have differed, and new approaches have evolved. Following the conclusions and policy options formulated so far, another ten major policy conclusions must be put forward here (Kolodko 1999a).

First, institutional arrangements are the most important factor in the achievement of fast and durable growth. They should be established through a process directed by government (by design) rather than spontaneously (by chance). In those nations in which government has been committed to this approach, recovery has come sooner, growth has been more robust, and there are more prospects for sustainable development. Those countries in which government has relied on the spontaneous appearance of new institutions have not been able to manage this complex process adequately and are lagging behind both vis-à-vis systemic transition and the growth of the real economy. Institution-building must be a gradual process. The effects of specific inputs in this process must be constantly monitored, and policies must be regularly adjusted and corrected. One should not depend on the experiences in distorted market economies, but should understand the special features of the emerging postsocialist markets. This is especially true in privatization and the development of capital markets.

Second, the size of government is less important than the quality of government policies and the manner in which the changes are implemented (Tanzi 1997). In transition economies a profound restructuring of the public finance system is more important than is the downsizing of government. Fiscal transfers should be redirected from non-competitive sectors towards institution-building (including behavioral and cultural changes) and investments in human capital and hard infrastructure. Attempts to downsize government through expenditure cuts can do more harm than good in terms of recovery from transitional recession and the achievement of sustained and fast growth. Even if one believes that small government is better than big government (what usually is true), to downsize may lead to economic contraction and deterioration in standards of living. Expenditures should not be cut for the sake of the illusion of fiscal prudence, but should be restructured.

Third, if institutional arrangements are neglected and left to spontaneous processes and liberalized market forces, then there will be a systemic vacuum, and 'informal institutionalization' will occur. Spreading corruption and organized crime are extreme examples of informal institutional-

ization. These are the two principal diseases in countries in which liberalization and privatization have taken place under weak government. Governments may sometimes be too weak because they are too big, but in transition economies they are often too weak because they have been downsized too soon, before the emerging market and the NGOs were able to take over relevant functions of the state. Even if the aim of the downsizing is to reduce the scope of fiscal redistribution so as to encourage capital formation, and hence investment and growth, one must not overlook the fact that the struggle against informal institutions is costly in fiscal terms, too. A prematurely or too thoroughly downsized government may not be strong enough to lead in this struggle, and the market may quickly expand within the informal sector, while the difficulties are mounting in the official economy. Thus, profits accrue to the informal sector, while revenues drop in the official sector. Profits are thereby 'privatized', while loses are 'socialized' in a politically unsustainable process full of negative consequences for the budget and for social policy.

Fourth, in transition economies policies must aim at transforming and streamlining the legal system so that it can serve the market economy. The establishment and development of new laws—trade and tax codes, capital market regulations, the protection of property rights, antitrust regulations, banking supervision, consumer protection, environmental protection—are extremely important and ought to be addressed before state assets are fully privatized. The establishment of a legal framework that is appropriate for the market economy should be much higher on the agenda of international financial organizations. It must be a more urgent and important issue than trade liberalization and assets privatization, since these latter can contribute to sound growth only if the former has been assured.

Fifth, a shift in functions from the central government to local governments is necessary for deregulation in the postsocialist economy. This means that some decentralization must be undertaken in the public finance system and that local governments must be given more fiscal autonomy. The process of taking functions away from the central government must be matched by reinforcing local governments. Both levels of government must be seen as two parts of a single entity, which is essential for gradual institution-building. If local governments are not strengthened as the central government is reduced, then healthy market forces cannot be supported by new institutional arrangements, and liberalization and privatization are less likely to improve capital allocation and raise efficiency.

Sixth, the development of non-governmental organizations must be accelerated. More significant international technical and financial assistance must be channeled into the effort to empower non-governmental organizations. Along with the private sector and the state, these organizations are an indispensable third pillar of the contemporary market economy and civic society. A wide range of non-governmental organizations active in various

areas of public life is needed to ease the constant tension between the state and society. The expanding private sector alone cannot adequately fill this gap. Certain areas of public life can rely neither on the state, nor on the business-oriented private sector. Without the institutional infrastructure provided by non-governmental organizations, successful systemic change and high-quality growth become more problematic, the infant market economy and democracy in postsocialist nations cannot evolve properly, and the transition will remain incomplete.

Seventh, income policy and equitable growth are very important for the growth sustainability and thus the ultimate success of the transition (Tanzi, Chu, and Gupta 1999). Because increasing inequity is unavoidable during the initial years of transition, the state, through fiscal and social policies, must play an active role in managing income dispersion. Beyond a certain limit, income disparities inhibit the expansion of economic activity, delay recovery, and slow down economic growth. Substantial inequities hamper crucial institutional and structural reform.

Eighth, the postsocialist transition to a market economy is taking place in a context of globalization. Hence integration with the world economy is an indispensable part of the process. This must be managed carefully. Special attention must be paid to short-term capital liberalization, which must be monitored and controlled by fiscal and monetary authorities and supported by international financial institutions. It is better to liberalize capital markets later rather than sooner. Institution-building must first be sufficiently advanced, and stabilization ought to be already consolidated into stability. Only then should financial markets be liberalized in a gradual manner. Otherwise the populations in the young and emerging democracies will not back the introduction of market mechanisms or integration with the world economy and may even become hostile to these steps.[1]

Ninth, international organizations not only should support globalization, but ought to encourage regional integration and cooperation. Fast and durable growth requires export expansion, which depends on strong regional linkages. In turn, this calls for institutional support through import-export banks, commodity exchanges, credit insurance agencies, and

1. Actually, the rampant demonstrations during the summit of the World Trade Organization in Seattle in September 1999, during the World Economic Forum in Davos in January 2000, and at the time of the UNCTAD meeting in Bangkok in February 2000, as well as in certain other places where the international organizations gather for their meetings, are clearly corresponding with such a diagnosis. However, these demonstrations were organized vis-à-vis a wider scope of issues linked (or only believed to be so) to certain by-effects of globalization in developing countries. It must be remembered that from this angle the postsocialist economies have taken many of the features of such economies. Hence, it may happen that the anti-globalization sentiments will rise as transition and its globalization aspect will evolve still further. It should be the opposite, yet in the foreseeable future, this may happen in several countries. In this odd way, globalization is turning against itself.

so on. This should be the main focus of the institution-building effort of the EBRD through its direct lending and technical assistance. This sort of market infrastructure is now underdeveloped in transition economies, and regional trade and direct cross-country investment are lagging behind in the process of changes. What should be a driving force behind sustainable growth is actually now a major obstacle.

Tenth, the Bretton Woods institutions should reconsider their policy approach towards transition economies. While the IMF should emphasize financial liquidity, currency convertibility, and fiscal and monetary stabilization, the World Bank should focus mainly on supporting equitable growth and sustainable development. These two areas of economic policy are frequently at odds. There is a tendency to confuse the means and the ends of policy, to favor short-term stabilization over long-term growth and development. Decisionmakers should not rely only on stabilization policies, but should seek a proper balance between stabilization policies and medium- and long-term development strategies. Fiscal and monetary policies must be subordinated to development policy—not the other way around. The World Bank performance criteria for socioeconomic development are needed as much as are the IMF fiscal and monetary criteria. There should always be an eye on the impact of financial policies in terms of growth, capital allocation, income distribution, and the social safety net.

As conditions change and challenges appear, policies must be revised in the future as well. Consequently, the quest for a comprehensive and achievable policy consensus, which facilitates sustained and fast growth, must be ongoing, especially since there is the occasion to catch up. Such chance should not be lost.

Statistical Appendix:

From Growth Cycles under a Centrally Planned Economy to Business Cycles under a Market Economy, 1950–2004

Fig. 6 Economic Growth Cycles in Bulgaria
(1953-2004)

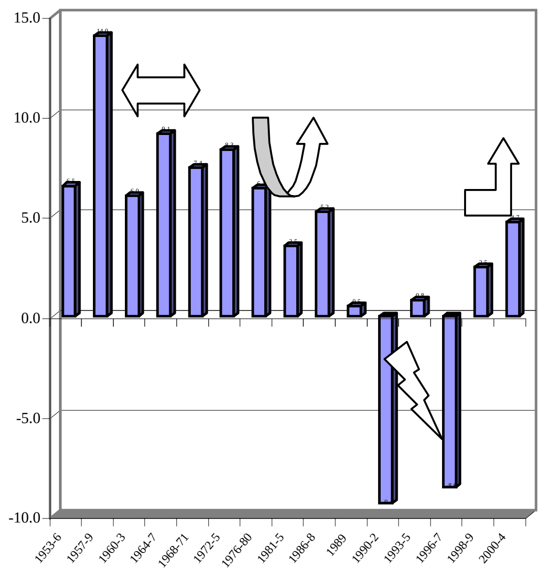


Fig. 7 Economic Growth Cycles in Czechoslovakia
(1950-92) and the Czech Republic (1993-2004)

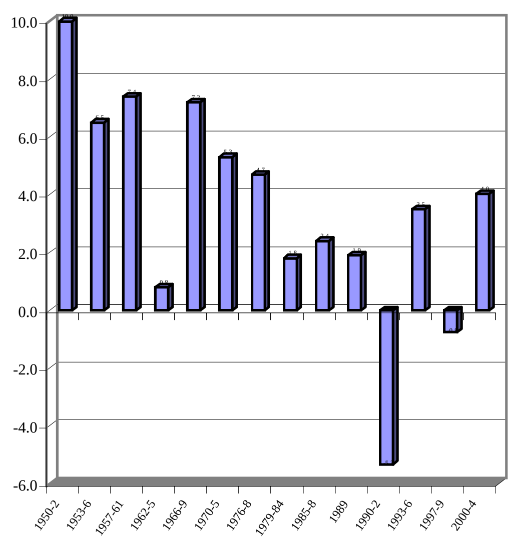


Fig.8 Economic Growth Cycles in Czechoslovakia
(1950-92) and Slovakia (1993-2004)

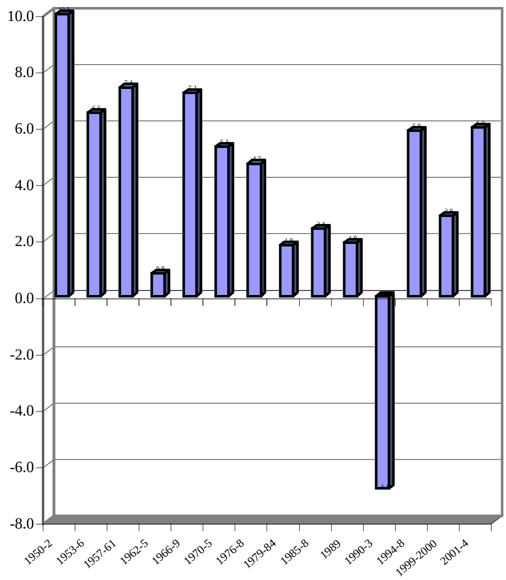


Fig. 9 Economic Growth Cycles in Hungary
(1951-2004)

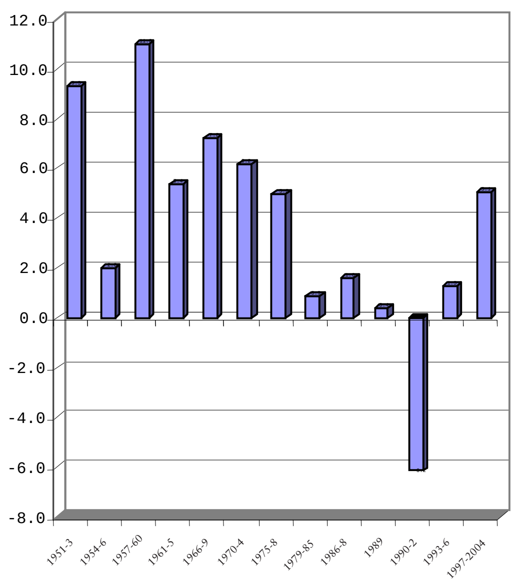


Fig. 10 Economic Growth Cycles in Poland
(1950-2004)

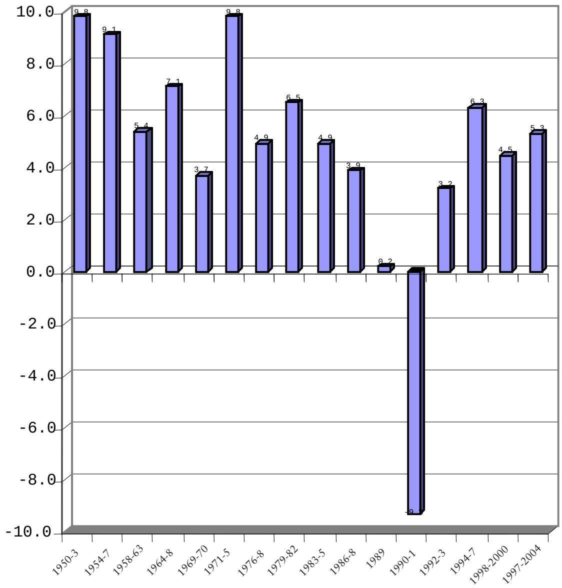


Fig. 11 Economic Growth Cycles in Romania
(1951-2004)

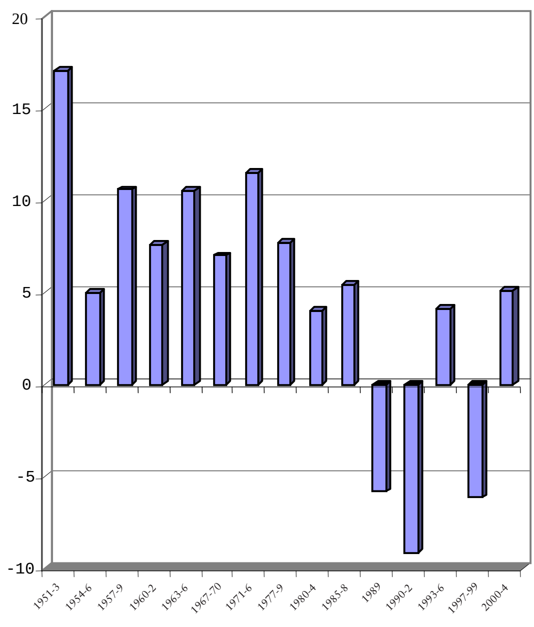


Fig. 12 Economic Growth Cycles in the Soviet Union (1950-88) and Armenia (1989-2003)

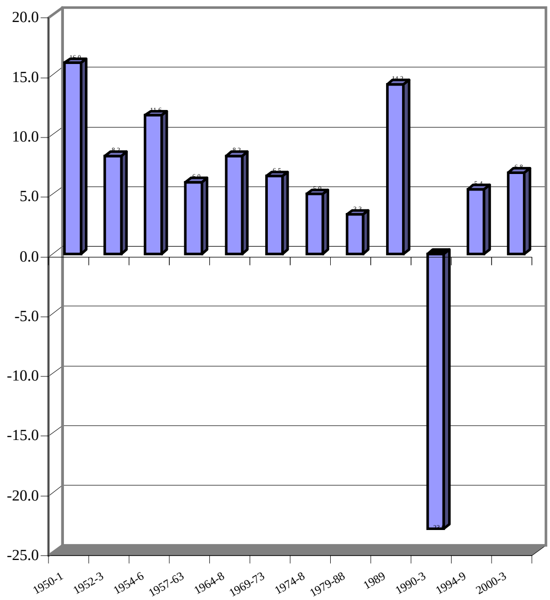


Fig. 13 Economic Growth Cycles in the Soviet Union (1950-88) and Estonia (1989-2003)

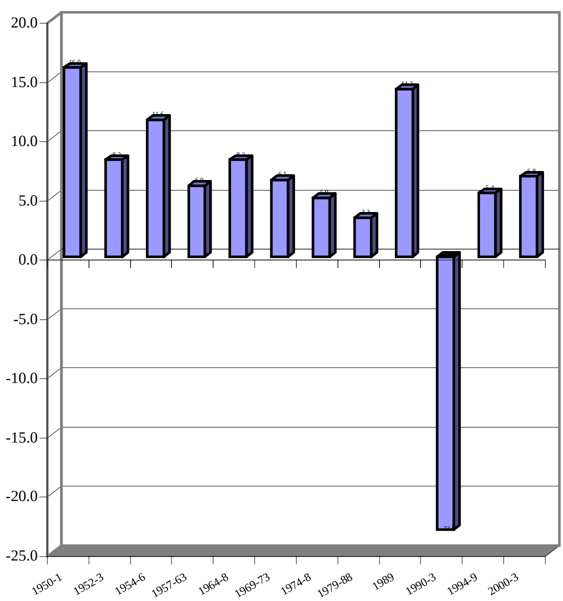


Fig. 14 Economic Growth Cycles in the Soviet Union (1950-88) and Moldova (1989-2003)

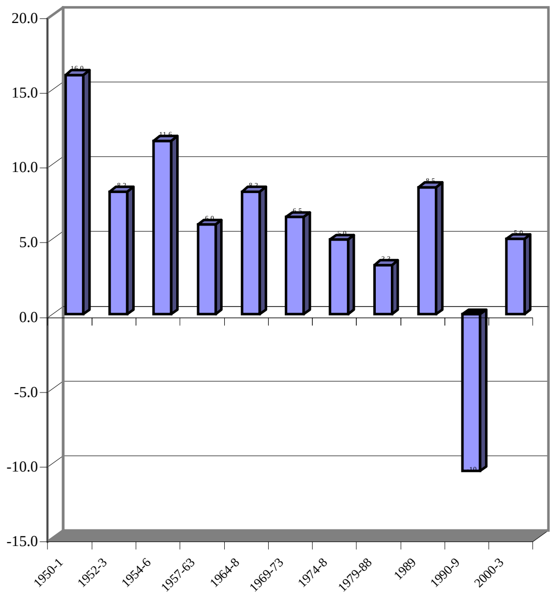


Fig. 15 Economic Growth Cycles in the Soviet Union (1950-88) and Russia (1989-2003)

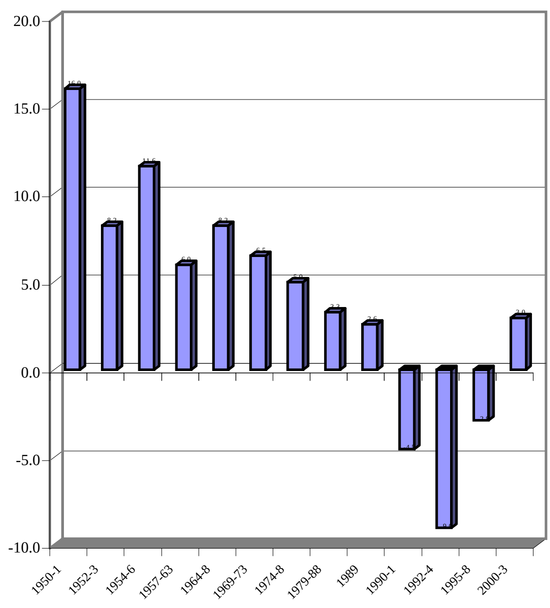


Fig. 16 Economic Growth Cycles in the Soviet Union (1950-88) and Ukraine (1989-2003)

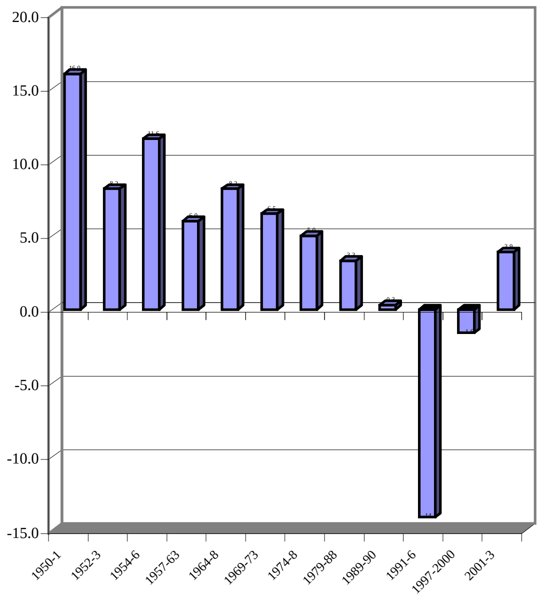
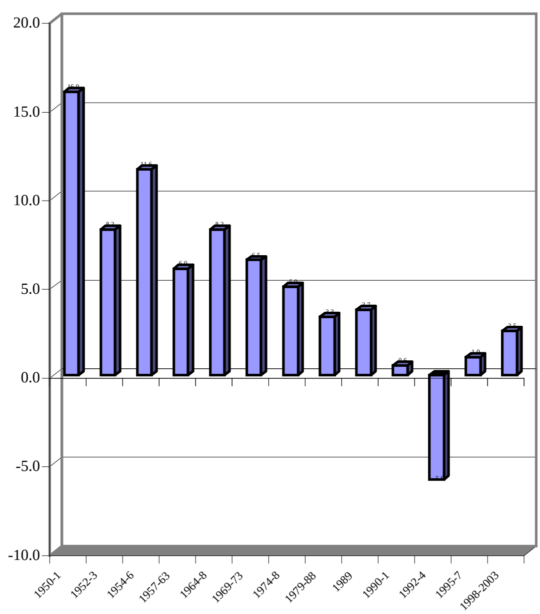


Fig. 17 Economic Growth Cycles in the Soviet Union (1950-88) and Uzbekistan (1989-2003)



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Abstract

The transitional recession in Eastern Europe and the former Soviet Union has been more severe and has lasted much longer than expected. It has been the result of both the legacy of the past and of contemporary policy mistakes. Due to structural reforms and gradual institution-building, the postsocialist economies have started to recover, and some leading countries have been able to build up a certain amount of momentum towards fast growth. There is a possibility that, within the wider context of globalization, several of these emerging market economies will be able, in a matter of one or two generations, to catch up with the more advanced industrial countries. Yet the final outcome of the whole transition process will depend on the quality of growth policy and the coordination between development strategy and the vast effort at structural reform. Transition and globalization both represent a challenge and an opportunity for these countries to catch up with the developed economies.

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